the CATO JOURNAL

AN INTERDISCIPLINARY JOURNAL OF PUBLIC POLICY ANALYSIS

THE TRANSFER SOCIETY

Charles Murray	*Losing Ground* Two Years Later
Greg J. Duncan and Saul D. Hoffman	Welfare Dynamics and the Nature of Need
June O'Neill	Transfers and Poverty: Cause and/or Effect?
Edgar K. Browning and William R. Johnson	The Cost of Reducing Economic Inequality
James Gwartney and Richard Stroup	Transfers, Equality, and the Limits of Public Policy
Gordon Tullock	Transitional Gains and Transfers
Richard E. Wagner	Wealth Transfers in a Rent-Seeking Polity
Robert W. Crandall	Economic Rents as a Barrier to Deregulation
Peter J. Ferrara	Intergenerational Transfers and Super IRAs
S. Anna Kondratas	The Political Economy of Work-for-Welfare
Bruce Gardner	Farm Commodity Programs as Income Transfers
Bruce L. Benson and M. D. Faminow	Regulatory Transfers in Canadian/American Agriculture: The Case of Supply Management
Gary Fournier and David Rasmussen	Targeted Capital Subsidies and Economic Welfare
Terry L. Anderson and Peter J. Hill	Constraining the Transfer Society: Constitutional and Moral Dimensions
William A. Niskanen	A Constitutional Approach to Taxes and Transfers

VOLUME 6 NUMBER 1 • PUBLISHED BY THE CATO INSTITUTE • SPRING/SUMMER 1986

the CATO JOURNAL

VOLUME 6 NUMBER 1 • PUBLISHED BY THE CATO INSTITUTE • SPRING/SUMMER 1986

Editor
JAMES A. DORN

Assistant Editor
CATHERINE ENGLAND

Production
DAVID LAMPO

EDITORIAL BOARD

TERRY L. ANDERSON
Montana State University

CHARLES W. BAIRD
California State University
at Hayward

T. E. BORCHERDING
Claremont Graduate School

YALE BROZEN
University of Chicago

KARL BRUNNER
University of Rochester

JAMES M. BUCHANAN
Center for Study of
Public Choice
George Mason University

EDWIN DIAMOND
Massachusetts Institute
of Technology

ARTHUR A. EKIRCH
State University
of New York at Albany

RICHARD A. EPSTEIN
University of Chicago

STEVE H. HANKE
Johns Hopkins University

C. LOWELL HARRISS
Columbia University

FRIEDRICH A. HAYEK
University of Freiburg

LEONARD P. LIGGIO
Institute for
Humane Studies

SAM PELTZMAN
University of Chicago

ALVIN RABUSHKA
Hoover Institution
Stanford University

EARL C. RAVENAL
Georgetown University

VERNON L. SMITH
University of Arizona

ROLAND VAUBEL
Mannheim University

KAREN I. VAUGHN
George Mason University

RICHARD E. WAGNER
Florida State University

LAWRENCE H. WHITE
New York University

LELAND B. YEAGER
Auburn University

The CATO JOURNAL (ISSN 0273-3072) is published in the spring/summer, fall, and winter by the Cato Institute, 224 Second Street SE, Washington, D.C. 20003. Annual subscriptions are $18.00 for both individuals and institutions. Single copies are $6.00. Two-year subscriptions are $36.00 and three-year subscriptions are $54.00. Foreign subscribers should add $5.00 per year for regular delivery and $10.00 per year for airmail delivery.

Correspondence regarding subscriptions, changes of address, procuring back issues, advertising and marketing matters, etc., should be addressed to the Publications Department. All other correspondence, including requests to quote or reproduce material, should be addressed to the editor.

Unsolicited manuscripts cannot be returned and will be acknowledged only if accompanied by a stamped, self-addressed envelope. There is no submission fee. Articles should focus on specific public policy issues. Accepted manuscripts must conform to the CATO JOURNAL's style requirements. (A style sheet is available on request.)

Authors should submit three copies of their papers or communications to the editor. An abstract of no more than 250 words should also be included to aid referees. Manuscripts should have wide margins and be double-spaced throughout, including footnotes.

Unsolicited book reviews cannot be returned and will be acknowledged only if they are accepted for publication. They should conform to the above requirements, and should provide an in-depth analysis of major studies of public policy. Reviews should range from 800 to 1000 words.

The views expressed by the authors of the articles are their own and are not attributable to the editor, the editorial board, or the Cato Institute.

The CATO JOURNAL is indexed and abstracted in the *Journal of Economic Literature, Current Contents/Social and Behavioral Sciences, Social Sciences Citation Index*, and the ABI/INFORM database. The CATO JOURNAL is available on microfilm from University Microfilms International, Ann Arbor, Michigan 48106.

Printed in the United States of America.

Copyright © 1986 by the Cato Institute.
All rights reserved.

CATO JOURNAL VOLUME 6 NUMBER 1 SPRING/SUMMER 1986

THE TRANSFER SOCIETY

Introduction 1

Charles Murray
Losing Ground Two Years Later 19

Greg J. Duncan and Saul D. Hoffman
Welfare Dynamics and the Nature of Need 31

June O'Neill
Transfers and Poverty: Cause and/or Effect? 55

Comment by Janet E. Kodras 77

Edgar K. Browning and William R. Johnson
The Cost of Reducing Economic Inequality 85

James Gwartney and Richard Stroup
Transfers, Equality, and the Limits of Public Policy 111

Comment by Mark Lilla 139

Gordon Tullock
Transitional Gains and Transfers 143

Richard E. Wagner
Wealth Transfers in a Rent-Seeking Polity 155

Robert W. Crandall
Economic Rents as a Barrier to Deregulation 173

Peter J. Ferrara
Intergenerational Transfers and Super IRAs 195

Comment by A. Haeworth Robertson 221

S. Anna Kondratas
The Political Economy of Work-for-Welfare 229

Comment by William A. Darity, Jr. and Samuel L. Myers, Jr. 245

Bruce Gardner
Farm Commodity Programs as Income Transfers 251

Comment by E. C. Pasour, Jr. 263

Bruce L. Benson and M. D. Faminow
Regulatory Transfers in Canadian/American Agriculture: The Case of Supply Management 271

Gary Fournier and David Rasmussen
Targeted Capital Subsidies and Economic Welfare 295

Comment by J. Ronnie Davis 313

Terry L. Anderson and Peter J. Hill
Constraining the Transfer Society: Constitutional and Moral Dimensions 317

Comment by Thomas S. McCaleb 341

William A. Niskanen
A Constitutional Approach to Taxes and Transfers 347

INTRODUCTION

THE TRANSFER SOCIETY

James A. Dorn

> Today, when it is an accepted principle that the function of the state is to distribute wealth to everybody, it is natural that the state is held accountable for this commitment. To keep it, it multiplies taxes and produces more poverty than it cures.
>
> —Frederic Bastiat

Written in 1848, Bastiat's statement is as appropriate for the United States today as it was for France in the mid-19th century.[1] At the time Bastiat wrote, the United States still adhered to the principles of property and contract inherent in the Founders' Constitution. "There is no country in the world," said Bastiat ([1850] 1964, p. 59), "where the law confines itself more rigorously to its proper role, which is to guarantee everyone's liberty and property [than in the United States]. Accordingly, there is no country in which the social order seems to rest on a more stable foundation."[2]

The rise of the U.S. welfare state—the transfer society—followed from the attenuation of private property rights and freedom of contract that occurred during the last part of the 19th century and accelerated with the demise of substantive economic due process in the 1930s. The direct transfers that followed are well known today: welfare expenditures in the form of Social Security, Medicare, Medicaid,

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

[1] Bastiat ([1848] 1964, p. 125).

[2] The two major exceptions to the protection of person and property that Bastiat ([1850] 1964, pp. 59–60) noted were slavery and tariffs: "Slavery is a violation, sanctioned by law, of the rights of the person. Protective tariffs are a violation, perpetrated by the law, of the right to property." These interventions, he thought, if unconstrained could "lead to the dissolution of the Union."

means-tested transfers such as Aid to Families with Dependent Children (AFDC), Food Stamps, and Supplemental Security Income (SSI), to name a few. Perhaps less well recognized, but as important, are the indirect transfers to businesses and middle- and upper-class individuals. These are generally couched in regulations that take the form of price controls, licensing, trade restrictions, tariffs, environmental regulation, zoning laws, and tax preferences.

To assess the various transfers that have arisen, especially in the postwar era, the **Florida State University Policy Sciences Program** sponsored its Second Annual Critical Issues Symposium, "The Political Economy of the Transfer Society," March 5–6, 1986, in Tallahassee. The conference papers published in this volume provide a wide-ranging discussion of the impact the growth of transfers has had on economic incentives and individual behavior. Understanding the effect of attenuating private property rights on wealth creation, as well as on individual freedom and responsibility, is critically important as we try to put our financial house in order, spur economic growth, and deal with the problems of poverty. Approaching the Constitution's bicentennial in 1987 also makes it an appropriate time to reflect on whether the modern welfare state is compatible with the principles of "life, liberty, and property" that were so revered by the Founders.[3]

---

[3] The importance that James Madison placed on the right to property (broadly defined) and its safeguarding by the state is clearly revealed in his essay "Property," written for the *National Gazette* in 1792:

> In its larger and juster meaning, it [property] embraces every thing to which a man may attach a value and have a right; and *which leaves to every one else the like advantage*. . . . [Thus] a man has a property in his opinions and the free communication of them. He has a property of peculiar value in his religious opinions, and in the profession and practice dictated by them. He has a property very dear to him in the safety and liberty of his person. He has an equal property in the free use of his faculties and free choice of the objects on which to employ them. In a word, as a man is said to have a right to his property, he may be equally said to have a property in his rights. . . .
>
> Government is instituted to protect property of every sort; as well that which lies in the various rights of individuals, as that which the term particularly expresses. This being the end of government, that alone is a *just* government, which *impartially* secures to every man, whatever is his *own*. . . .
>
> That is not a just government, nor is property secure under it, where the property which a man has in his personal safety and personal liberty, is violated by arbitrary seizures of one class of citizens for the service of the rest.

Madison's view of property and the role of the state precludes the type of redistributive activities that are the trademark of the modern liberal state. His view of property was shared by his contemporaries (see Siegan 1980; Anderson and Hill 1980; Epstein 1985b).

Transfers as Takings

The basic characteristic of government transfers, including both welfare and regulatory transfers, is their coercive nature. In contrast to voluntary transfers, which depend on the consent of the donors, government transfers attenuate private property rights and reduce individual freedom. This is as true for land use regulation and wage and price controls as it is for welfare payments (see Epstein 1985b, ch. 17). As such, the redistributive state is incompatible with Madison's concept of a just state, namely, one that protects the property right, broadly understood as the protection of one's life, liberty, and possessions (supra, n. 3).

Economic legislation, catering to special interests, and entitlement programs ("welfare rights") fail the nondiscrimination test: those individuals and groups who are politically powerful are able to use the force of law to confer benefits on themselves at the expense of other citizens. When seen in this light, the modern democratic state is nothing but an agent for special interests seeking to take private property without the consent of the rightful owners. As such, Bastiat's term "legal plunder" seems appropriate to describe the forced redistributions and regulatory transfers that occur through the law-making process in democracies with virtually unlimited majoritarian rule.[4]

Unlike the older classical concept of justice as a *process*—commutative justice—characterized by voluntary consent (unanimity) and mutual gain, the modern concept of distributive or social justice is an *end-state* concept that is inconsistent with private property rights and individual freedom. Instead of affording individuals equal protection under the law, the modern liberal state uses the democratic process to control prices, restrict entry, and redistribute property according to popular sentiment.[5] And instead of individuals voluntarily accepting the *negative* obligation to refrain from coercion except in the defense of property, social justice imposes a *positive* legal obligation to redistribute one's property to lower income groups. Welfare rights therefore are incompatible with private property rights, that is, with an individual's fundamental right to noninterference which lies at the core of a free society.[6]

---

[4] By "legal plunder" Bastiat ([1850] 1964, p. 61) understood an illegitimate use of force—the law—to redistribute property rather than protect it. To recognize legal plunder, one has only to "see whether the law takes from some what belongs to them in order to give it to others to whom it does not belong."

[5] Popular sovereignty should not be confused with private sovereignty—the former extends state power while the latter limits it to protection of person and property (see Pilon 1985). Without constitutional limits on government taking, there is no limit to the extent of redistribution that can be "justified" in the "public interest."

Fleshing out the logic of this position, Pilon (1979a, p. 148) argues:

> It is only by eliminating the right to welfare, then, at least in the various forms in which it entails positive obligations, that we can have a world of nonconflicting rights . . . , a world in which we can at all times enjoy whichever exemplifications of our right to noninterference [i.e., to property in the Madisonian sense] we choose to enjoy, subject only to the restrictions we incur as a result of our own actions.

A world of consistent and equal rights, in effect, implies a world of maximum freedom in which all those rights that can be exercised without interfering with the equal rights of others are passed on to individuals and safeguarded by the state.[7]

From this perspective, the state has no right to take the property of some for the benefit of others, for there is no contractual obligation to help the poor (or the nonpoor who receive the bulk of government transfers). Yet, it is not inconsistent to say that from an ethical viewpoint we *ought* to help those individuals who legitimately cannot support themselves. Only *voluntary* transfers, however, are consistent with the real meaning of charity. Such transfers do not violate the right to noninterference, which implies the correlative obligation not to take from others what is rightfully theirs—their life, liberty, and possessions.[8] When the state engages in taking private property for redistributive activities, including regulatory transfers, it is not engaging in private charity but in legal plunder.

---

[6] See Nozick (1974, pp. 153–60) on the distinction between procedural and end-state justice; see Hayek (1976) on the distinction between the classical concept of a just process under a rule of law and social justice; see Pilon (1979b, pp. 1340–41) on the basic right to noninterference that characterizes a free society and its inconsistency with modern "welfare rights."

Epstein (1985b, especially chs. 17 and 19) views regulatory transfers and welfare rights as takings. With respect to welfare payments (so-called entitlements), he notes: "The basic rules of private property are inconsistent with any form of welfare benefits" (p. 322).

[7] In "a world of consistent rights," says Pilon (1979a, p. 148), "everyone can enjoy whichever of his rights he chooses to enjoy at the same time and in the same respect that everyone else does, and the negative obligations correlative to these rights can be satisfied by everyone at the same time and in the same respect that he enjoys his own rights to noninterference." Consequently, Pilon (1983, p. 175) reasons:

> [T]he free society is a society of equal *rights:* stated most broadly, the right to be left alone in one's person and property, the right to pursue one's ends provided the equal rights of others are respected in the process, all of which is more precisely defined by reference to the property foundations of those rights and the basic proscription against taking that property. And the free society is also a society of equal *freedom,* at least insofar as that term connotes the freedom from interference that is described by our equal rights.

Compare Jensen and Meckling (1985) on the definition of maximum freedom, and Meckling and Jensen (1980) on the nature of rights, which they classify as "scarce rights" and "non-scarce rights."

The Rise of Rent Seeking

By straying from the principles of property and justice as understood by the Founders, the modern liberal state has seen the erosion of private property rights, the demise of the rule of law, and the rise of "rent seeking." In the absence of effective constitutional protection for private property rights and freedom of contract—protection the Founders envisioned but the courts have eroded—the modern welfare state has increased uncertainty regarding the tenure of ownership claims. By deferring to the legislative will in the area of economic rights, the judiciary has paved the way for special interest groups to work to capture the political branches with adverse effects for individual freedom (see Pilon 1985). Lobbying for political favors and special interest legislation—rent seeking—has become the dominant game in the nation's capital.

Rent seeking is the natural outcome of the interventionist, neomercantilist state. It is only when the state goes beyond protecting property to redistributing it at will that it becomes profitable to divert resources to actively seek political favors. Self-interested politicians in a democratic setting and operating within a common property regime will be led to those activities that increase the chance of being elected. Conditioned by the expectation that the judiciary will not overturn economic legislation attenuating private property rights if it appears to be in the "public interest," legislators will respond forcefully to the wishes of those special interest groups that command strong political support. And those will be the groups that expect large benefits for themselves and are able to disperse and hide the real costs of their programs.

Property rights theory is useful in deriving the implications of alternative rights structures on incentives and behavior, and public choice theory helps explain why government decision makers have especially strong incentives to deviate from wealth maximization in allocating resources; that is, why it pays politicians and bureaucrats to divert resources from those uses that would maximize the value of output to consumers, voters, and taxpayers. The fact that the present transfer society is inefficient in this sense should not surprise us; nor should it surprise us that giving public officials better information about how to increase efficiency in government will not necessarily change their behavior. Behavior will change only if the underlying cost-reward structure is changed so that decision makers within government bear more of the costs of their inefficient decisions and can capture more of the benefits of increased efficiency (see McKean 1972).

---

[8] See Pilon (1979b, pp. 1341–44) for a discussion of the difference between ought and obligation in the context of a rational theory of rights and the problem of justification. Also see Epstein (1985b, ch. 19) where he explains that although no one has a legal obligation to aid the less fortunate, this is not to say that there is no moral duty to do so. The duty, however, must be accompanied by a spontaneous giving rather than by a deliberate taking. In a free society, individuals cannot be compelled to charitable behavior without destroying the true meaning of charity.

The rise of rent seeking is a case of government failure, in this instance a failure to afford property rights and economic liberties the same protection as First Amendment rights. Once it became generally accepted in the late 1930s that the Supreme Court would no longer apply substantive due process to economic legislation, the door was opened for all sorts of legislative mischief in the name of social justice.[9] The resulting politicization of private (voluntary) transfers then became inevitable. As Epstein (1985b, p. 322) notes:

> The short truth is that if the state had never undertaken welfare programs, the demand for them would be a tiny fraction of what it is today. . . . The higher the level of benefits, the greater the demand, until the political dynamic—rent seeking again—produces an aggregate demand that the system itself can meet only with great cost to its productive capacities.

---

[9] Tumlir (1985, p. 14) states: "If we are to explain the rise of rent seeking to a dominant form of democratic politics, we must focus on the change in constitutional interpretation." The undermining of private property rights and freedom of contract was a lengthy process beginning in earnest with Munn v. Illinois (1877) and continuing with the demise of substantive economic due process in Nebbia v. New York (1934), West Coast Hotel v. Parrish (1937), and United States v. Carolene Products Co. (1938). Together with the Court's decision in United States v. Butler (1936), which effectively removed the limit on direct federal transfers under Article I, section 8, these cases paved the way for the modern welfare state. For a fuller discussion, see Anderson and Hill (1980), Niskanen (1985), Siegan (1980). The Court's more recent record in failing to protect economic liberties is discussed in Aranson (1985) and Epstein (1985a, 1985b).

According to Tumlir (1985, p. 14), the ushering in of the rational basis test of the Carolene Products case not only effectively terminated substantive due process for economic legislation, it also "discontinued the central element of any meaningful procedural review, namely the scrutiny of the conditions on which Congress delegates legislative power to the executive." This termination of the delegation doctrine, says Tumlir, "changed the nature of the legislative function and introduced a new form of politics"—rent seeking.

Thus, with fewer and fewer effective constraints on government taking, the rent-seeking process feeds on itself with a consequent growth of the transfer society.

The Growth of Transfers

The birth and growth of the transfer society was not due fundamentally to rent seeking; it was the predictable outcome of the lack of resolve on the part of the judiciary to protect economic rights; it was the crumbling of the rule of law (see Tumlir 1985, p. 16). For nearly a century after the Constitution's ratification, the lack of any effective provision for federal transfer programs and the widespread acceptance of the Founders' intent to limit the state to protection of property (broadly conceived) strictly limited redistributive programs. Even as late as 1929, direct federal transfer payments were less than 1 percent of GNP.[10]

The cracking of the constitutional foundation supporting property rights and freedom of contract became serious with the New Deal era and the demise of substantive due process in reviewing economic legislation. The Great Society programs of the 1960s and the socioeconomic regulations of the 1970s spurred the postwar growth of the transfer society. Thus, from virtual nonexistence in 1929, federal government transfer payments to persons as a share of GNP increased to 4.2 percent in 1964—one year before the War on Poverty was initiated—and more than doubled by 1984 to 9 percent. Expressed as a percent of disposable (after-tax) income, the federal transfer share increased from 6.1 percent in 1964 to 12.8 percent in 1984. At all levels of government, transfer payments to persons increased from about 6 percent of GNP in 1964 to nearly 12 percent in 1984, paralleling the growth of federal transfers (*Economic Report* 1986, app. B). If the increase in regulatory transfers were included in these figures, the resources diverted through transfers would be even greater.

Although real means-tested entitlement costs increased by 7.4 percent per annum for the 1970–81 period, they are scheduled to fall by −2.5 percent per annum for the 1981–88 period. However, the overall entitlement claim on GNP for federal transfers (including Social Security, Medicare, and Medicaid) is expected to climb to 10.1 percent by 1988 (Executive Office 1983, p. 3-27). Unless the Court returns to its original role of protecting property rights and freedom of contract from abuse by the political branches, or until effective constitutional constraints are imposed on the tax and transfer powers of government, the redistributive activities and rent seeking are unlikely to be curtailed.

---

[10] See Niskanen (1985, pp. 1–8).

The Political Economy of Transfers

The transfer society is inexorably linked to the democratic-majoritarian political process in which the principle of nondiscrimination or equality before the law is no longer binding (see Tumlir 1985, pp. 70–71). Any serious attempt to understand the growth of transfers must therefore consider the *political economy* of welfare and rent seeking. In this endeavor the role of the political entrepreneur is of special importance. This role has been noted by Allen Wallis (Tobin and Wallis 1968, p. 47):

> The task of the political entrepreneur . . . is to identify services which are being purchased by substantial and identifiable blocs of his electorate and to devise means by which the cost of these services will be transferred to the public. . . . Only if fairly large numbers of voters are already paying for the service will the offer to relieve them of the cost be likely to influence their votes.

The significance of this point for explaining the growth of government transfers often has been overlooked.

As empirical support for his insight, Wallis (pp. 44–47) offered the examples of education and health care. These services were purchased privately by a large number of people prior to the government's involvement. What the government did was to socialize the costs of these services via taxation and then hide the true cost via subsidies. Making education and health care appear as free goods was politically appealing and hence passed the vote-getting test of the political entrepreneur. With respect to health care, Wallis observed that at the time Medicaid was enacted 72 percent of the civilian population were already covered by private health insurance and that proportion was accelerating.

Pursuing Wallis's line of argument, one could reason that the general acceptance of social justice as a state goal made it politically profitable to have the state socialize and politicize specific private transfers. Yet state transfers are a prime example of government failure, as noted: namely, the failure to protect private property from the will of the majority, that is, from the will of those special interest groups that can command a majority vote in the legislature. The increased substitution of public takings for voluntary exchanges—of which private charity is a specific example—has proven to be an inefficient way to help the poor. The incentive structure facing government decision makers has resulted in a tax and transfer system that provides disincentives to work, save, and invest; a system characterized by rent seeking and horizontal as well as vertical transfers. Moreover, in attenuating private property rights and individual initiative, the government has dampened the most effective, long-run antipoverty program—economic growth. These and other aspects of the political economy of transfers were the subject of the Florida State University conference, the papers from which will now be summarized.

Two years after his provocative book *Losing Ground* (1984), Charles Murray points out in his paper that the existence of a large underclass is no longer questioned. Although many of the poor are transitory, there is still a sizable number who are permanent wards of the state. These individuals, who lack the marketable skills and work ethic necessary for self-sufficiency, remain testimony to the inherent problems of the welfare state. What concerns Murray now is that prospective reforms of the transfer society may miss the mark. Requiring work-for-welfare and child support by absent fathers under AFDC may marginally improve the welfare system, but such reforms are unlikely to have a significant, long-run effect on reducing welfare dependency. Recipients will have an incentive to adjust their behavior to evade new rules and the welfare bureaucracy will have little incentive to enforce rules that could injure their business. If the new welfare reforms unfold in this manner, Murray warns that the older racism may reappear, stigmatizing the poor. He foresees an era in which we begin to repeat old mistakes and asks how social scientists might prevent this. In general, Murray would like to see more emphasis placed on the white underclass to demonstrate that behavioral responses to welfare are universal rather than specific to poor minorities. He also recommends greater use of direct observation and qualitative data in studying the causal link between poverty and welfare. Finally, Murray would like social scientists to widen the scope of their regression models and rethink the definitions of their dependent variables—for example, whether the poverty variable should include only pretransfer income, as he has recommended.

Greg Duncan and Saul Hoffman question the argument first proffered by Murray in *Losing Ground*: namely, that the War on Poverty programs exacerbated rather than reduced poverty. The use of longitudinal as opposed to cross-sectional data shows that welfare programs generally have not been injurious to the poor. Those on welfare are typically on it for a short duration and do not become permanently dependent on the state. The authors therefore see the welfare system as a means of providing insurance against temporary poverty and not as a major source of long-term dependency. Nevertheless, they note the existence of several million hard-core poor who persistently look to the state for their livelihood. Whether welfare increases divorce rates and out-of-wedlock births while discouraging marriage, however, are unresolved questions that await better data and improved research methods.

June O'Neill cites welfare as one of several factors that affect individual choices regarding family status and work incentives, and notes the difficulties with econometric studies of the impact of welfare on poverty. What is clear, however, is that the major determinant of poverty is the state of the economy; that intergenerational transfers have reduced the elderly poor but at a very high cost; that the nonelderly poor have not been made appreciably better off as a result of transfers; and that "need" is the result of voluntary decisions regarding work, fertility, and marital status. In the past decade, for example, as real AFDC benefits have decreased, the rise of AFDC caseloads has been halted, there has been a slowdown in the number of female-headed households and a stabilization of the out-of-wedlock birth rate. O'Neill recommends some marginal reforms for AFDC that could help constrain the welfare state: limit the duration of AFDC, remove the no male-headed household requirement, and require absent fathers to provide child support to qualify for welfare.

Edgar Browning and William Johnson argue that the debate over whether the elimination of welfare would reduce poverty is misplaced; the relevant question is not whether total or average welfare spending affects poverty but whether a small change in welfare spending significantly affects poverty.[11] It is the *marginal cost* of the tax and transfer system that is important for policy reform. Browning and Johnson estimate the marginal cost of increasing the income of the poor and find that this cost is likely to be quite large, given the current level of tax and transfer programs. Indeed, further increases in redistributive tax and transfer programs are likely to be counterproductive, especially in the long run. The adverse effects of taxes and transfers on labor-supply decisions and saving and investment plans account for the high marginal cost of the tax and transfer system on the nonpoor. A much less costly way to help the poor would be to achieve higher rates of economic growth. Real transfer payments then could increase without increasing taxes, while transfers as a percent of national income remained constant.

---

[11] The Browning and Johnson paper was not originally presented at the Florida State University conference.

James Gwartney and Richard Stroup take a public choice perspective in viewing the transfer society. They see a complex relationship between transfers and poverty but point to the nonegalitarian results that often accompany the existing tax and transfer system. The high implicit marginal tax rate on recipients of means-tested transfers, if they increase their market income, has a perverse work incentive effect. As such, a significant amount of the poor's transfer income may simply be replacement income rather than a net gain from welfare. In addition, the authors note that the lack of work experience adversely affects the long-run skill levels of those on welfare, reducing the value of their human capital. Without persistent employment, skills depreciate. Welfare programs, in effect, have fostered adverse economic incentives that harm the poor's long-run interests and have encouraged wasteful rent seeking. And even if some transfers are egalitarian, the rate of return equalization theorem tells us that the gains will be transitional. The authors further note that public aid has tended to crowd out private aid; that annual cash income has not been a satisfactory measure of well-being; that rationing transfers by linking them to asset ownership, specific behavior, or status causes predictable problems; and that the bulk of transfers go to the nonpoor. The overall success of the War on Poverty is therefore in doubt, especially in light of the fact that the official poverty rate for the nonelderly increased after 1968 even as spending on means-tested transfers rose dramatically.

Gordon Tullock uses the regulation of oil prices and the provision of public education as specific examples of income and wealth transfers. He explains why the state opts for a system of inefficient transitional transfers instead of transferring all the potential gains to citizens or selected subgroups via direct cash transfers or the creation of transferable shares. Tullock ascribes the waste inherent in existing transfer schemes to ignorance—the cost of acquiring information about real wealth positions—and to the nature of the political process. In a majoritarian democracy, direct cash transfers are too obvious a subsidy and would not secure congressional approval. Economic advisers therefore have little incentive to promote efficient transfers. The result is a political process characterized by inefficient (but hidden) transfers, rent seeking, and transitional gains. As long as government officials find in-kind transfers politically rewarding, better information about the costs of these inefficient transfers will not alter their behavior. Finally, even if transfers were more efficient, rent seeking could well increase as national income and the size of the pie to be redistributed increased. We therefore get what might be called Tullock's law of democratic rent seeking: "If there is more money to be obtained, more resources will be put into seeking it" (p. 154).

Richard Wagner applies public choice theory to help explain the welfare state as one form of a rent-seeking polity, which he argues is the natural outcome of an unlimited democratic state subject to majority rule. Unless the rules of the game are changed so that the same rules apply to both government and private sector behavior, and the rules limit the government to the protection of private property and freedom of contract, the growth of the welfare state is unlikely to be constrained. As such, entitlement and status increasingly will replace property and contract as the guiding principles for social organization, and individual freedom will diminish with the reduction of private options. Wagner notes, for example, that affirmative action is inconsistent with equal opportunity; it does not allow self-selection to operate spontaneously as it does in an equal opportunity regime based on private property rights. Differences in self-motivation and talent, then, will not propel the high achievers to the head of the pack and society will lose wealth in the process. An entitlement regime based on status ignores the principle of comparative advantage only at its own peril.

Robert Crandall emphasizes the point that recent deregulation in the airline and trucking industries was not the result of better information about the adverse effects of regulation; rather, it was the result of a favorable realignment of political forces. The fact that there has been no corresponding reduction of social regulation—as it effects the environment, health, and safety—is explained by the existence of large economic rents to the relevant interest groups. Rent seeking has been especially visible in the area of environmental regulation. In the legislative process the benefits flowing to industries in the Northeast and Midwest from more lenient pollution standards make it difficult for congressmen from these states to favor regulatory reform that would lead to an improved environment, since the present rules give their states a comparative cost advantage over high-growth industries in the Sun Belt. Environmental legislation, therefore, can be seen as a form of protectionism for the older, slower-growth industrial areas of the country. The rents accruing to well-organized special interest groups from the current maze of environmental, health, and safety regulation, in effect, act as an effective barrier to deregulation. Unless the political costs and benefits change, we should not expect the success of deregulation in the airline and trucking industries to spread to social regulation.

Peter Ferrara has been a persistent critic of Social Security and Medicare, which are by far the largest federal transfer programs, comprising over half of federal domestic spending and one-third of total federal spending. The growth of Social Security has paralleled the growth of the transfer society. To stem this growth Ferrara would privatize our costly Social Security program in its entirety. His Super-IRA plan would convert the present pay-as-you-go system of social insurance to a fully funded private system designed to promote individual responsibility, capital accumulation, economic growth, and higher returns to younger workers than they now can expect under Social Security. Ferrara argues that the transition to a private system will not harm the current beneficiaries and that his Super-IRA plan is a politically feasible solution to the inherently crisis-ridden Social Security system.

Anna Kondratas traces the recent history of workfare and applies economic theory to derive some implications of the proposed work-for-welfare plan. Although workfare and work-for-welfare may not reduce welfare costs, they may be marginally useful if they instill the work ethic and foster individual responsibility. Real reform, however, requires a fundamental change in the nature of the entitlement programs that now make it advantageous for the marginally poor to choose welfare rather than work. The notion that certain individuals are *entitled* to welfare by meeting specified criteria is not changed by making "work" one of those measures. The dependency, irresponsibility, and fraud accompanying the current system are unlikely to change much if work requirements are introduced. If the minimum wage and other impediments to employment for low-skilled workers remain intact, and if the starting wage for the workers is such that welfare is an attractive option, then it is probable that work-for-welfare will not significantly affect the tax and transfer system. The welfare program will remain subject to political pressures and if a person chose welfare initially, there is strong reason to expect him to adjust his behavior to qualify for welfare without choosing work under the new set of rules. Thus, the welfare state is flawed, says Kondratas, not because of the absence of a work requirement but because of the entitlement itself.

The paper by Bruce Gardner and the one by Bruce Benson and M. D. Faminow offer examples of rent seeking in agriculture. Gardner shows that farm commodity programs in the United States transfer large amounts of income to the nonpoor. The concentrated benefits and dispersed costs of these transfers assure their continued political support. Benson and Faminow carry the public choice analysis of agriculture to the case of supply management in Canadian poultry markets, showing why this type of regulatory transfer arose in Canada but not in the United States. Exploring different theories of regulation, the authors offer the interest group theory of regulation as the most useful approach to explain the difference in Canadian/U.S. agricultural policy. But they also rely on the theory of bureaucracy and differences in political institutions to help explain agricultural policy differences. The relatively larger size of Canada's agricultural bureaucracy and the parliamentary system point toward the relative importance of supply management in Canadian poultry markets.

Gary Fournier and David Rasmussen use the case of targeted business capital subsidies to illustrate the impact of one particular welfare program. Legislated aid to specific industries in the form of capital subsidies creates an opportunity for rent seeking. Targeted business capital subsidies also are a less efficient transfer than direct cash grants, but the reasons for their use should be clear from Tullock's paper.

Terry Anderson and Peter J. Hill emphasize the close link between effective constitutional reform and prior ideological consensus for limited government. They argue that the natural rights position of the Founding Fathers helped shape their choice of a constitutional government—one that narrowly limited redistribution and protected property rights. If most people agree on the basic ethical principles concerning the right to private property and freedom of contract, the costs of monitoring a limited government or constitutional regime will be lower than without such an ideological consensus. The erosion of private property rights in the modern welfare state has been accompanied by a decline in respect for the rule of law and, hence, for an individual's right to his property (broadly conceived). Unless the traditional principles of property and contract are restored, constitutional constraints are unlikely to be instituted, or if instituted, unenforced. The implementation and maintenance of a constitutional regime, therefore, will ultimately depend on the ideological basis of society.

In the final paper, William Niskanen takes a constitutional approach to the tax and transfer system, and attempts to answer the question of what constitutes a "fair" system. The criterion for a fair system or "game" is that there be a consensus on the rules of the game without knowing the specific outcomes. Using this rules-based approach, Niskanen illustrates the effect of alternative distribution schemes for unearned and earned income. With respect to the former, he demonstrates that the level of transfers would be influenced by the degree of uncertainty about the various outcomes, and that constitutional limits determine the range of taxes and transfers but may not determine the specific amounts. He models the redistribution of earned income to demonstrate the characteristics of an optimal tax and transfer system. The most important conclusion of this model is that the effective marginal tax rate should *decline* over the whole income distribution. By considering other conditions (for example, post-constitutional rent seeking, provision for protective services, and rights of emigration and secession), Niskanen arrives at a model for a constitutional regime that may allow little scope for redistribution. In this regard, he notes that the U.S. Constitution itself made no explicit provision for transfer payments. This changed in the 1930s, of course, with the *Butler* decision and the demise of substantive economic due process. The fundamental difficulty today, says Niskanen, is the absence of any effective constitutional limitation on the type or amount of government transfers.

Constitutional Limits on Transfers

Many of the papers in this volume suggest marginal reforms that would make the current tax and transfer system more efficient. The property rights and public choice perspectives, however, point toward the need for more fundamental constitutional reform—if the transfer society is to be constrained and ultimately replaced by a regime characterized by secure rights of property and contract. One important area for research is to reassess the role of the judiciary in protecting economic rights (which do not include positive "welfare rights").[12]

It is also important to consider the implementation and maintenance problems accompanying constitutional limits on the redistributive state. A closer examination of the cost-reward structure affecting government decision makers is important in this regard. Complementing such research would be a more thorough discussion of the effect of ideology on institutional change (along the lines of the Anderson and Hill paper), as well as a grounding of the ethical arguments for limited government in a more consistent, rational theory of rights (along the lines of Pilon's and Epstein's recent work).

The question of whether public aid is effective in reducing inequality and poverty is superseded by a more basic question that is often overlooked in public debate: whether it would be appropriate for the state to take private property for redistributive activities, *even if* such transfers were "efficient." Further, if empirical evidence points to the inefficiency of the transfer society in promoting private wealth creation, should we try to make the state as a redistributive agent more efficient or push the state out of this area entirely? These are important questions whose answers will ultimately depend on the desire of individuals for freedom from government coercion used to redistribute income in the name of social justice *plus* their knowledge of the effects of attenuated private property rights on wealth creation. The papers in this volume are an appropriate starting point for a rational discussion of the economic and ethical implications of alternative institutional regimes—as they affect wealth and freedom—and should pave the way for future research.

---

[12] See "Economic Liberties and the Judiciary," a special issue of the *Cato Journal* 4 (Winter 1985).

References

Anderson, Terry L., and Hill, Peter J. *The Birth of a Transfer Society.* Stanford, Calif.: Hoover Institution Press, 1980.

Aranson, Peter H. "Judicial Control of the Political Branches: Public Purpose and Public Law." *Cato Journal* 4 (Winter 1985): 719–82.

Bastiat, Frederic. "Justice and Fraternity." 1848. Reprint. In *Selected Essays on Political Economy,* pp. 116–39. Translated by Seymour Cain and edited by George B. de Huszar. Irvington-on-Hudson, New York: Foundation for Economic Education, 1964.

Bastiat, Frederic. "The Law." 1850. Reprint. In *Selected Essays,* pp. 51–96.

Economic Report of the President. Washington, D.C.: Government Printing Office, 1986.

Epstein, Richard A. "Judicial Review: Reckoning on Two Kinds of Error." *Cato Journal* 4 (Winter 1985a): 711–18.

Epstein, Richard A. *Takings: Private Property and the Power of Eminent Domain.* Cambridge: Harvard University Press, 1985b.

Executive Office of the President. Office of Management and Budget. *Budget of the United States Government Fiscal Year 1984.* Washington, D.C.: Government Printing Office, 1983.

Hayek, F. A. *Law, Legislation, and Liberty.* Vol. 2, *The Mirage of Social Justice.* Chicago: University of Chicago Press, 1976.

Jensen, Michael C., and Meckling, William H. "Human Rights and the Meaning of Freedom." Paper presented at the Liberty Fund Seminar on Human Rights and Freedom, Miami, Fla., 29–30 March 1985.

[Madison, James.] "Property." *National Gazette* 1, no. 44 (29 March 1792): 174–75. Reprinted in *Letters and Other Writings of James Madison.* Vol. 4, pp. 478–79. Philadelphia: J. B. Lippincott & Co., 1865.

McKean, Roland N. "Property Rights within Government and Devices to Increase Governmental Efficiency." *Southern Economic Journal* 39 (October 1972): 177–86.

Meckling, William H., and Jensen, Michael C. "A Positive Analysis of Rights Systems." Paper presented at the Seventh Annual Interlaken Seminar on Analysis and Ideology, Interlaken, Switzerland, 23 May 1980.

Munn v. Illinois 94 U.S. 113 (1877).

Murray, Charles. *Losing Ground: American Social Policy 1950–1980.* New York: Basic Books, 1984.

Nebbia v. New York 291 U.S. 502 (1934).

Niskanen, William A. "A 'Constitutional' Perspective on Social Welfare Policy." Paper presented at the Ford Foundation Conference on Social Welfare Policy and the American Future, Racine, Wis., 3–5 November 1985.

Nozick, Robert. *Anarchy, State and Utopia*. New York: Basic Books, 1974.

Pilon, Roger. "A Theory of Rights: Toward Limited Government." Ph.D. dissertation, University of Chicago, 1979a.

Pilon, Roger. "On Moral and Legal Justification." *Southwestern University Law Review* 11, no. 4 (1979b): 1327–44.

Pilon, Roger. "Property Rights, Takings, and a Free Society." *Harvard Journal of Law and Public Policy* 6 (Summer 1983): 165–95.

Pilon, Roger. "Legislative Activism, Judicial Activism, and the Decline of Private Sovereignty." *Cato Journal* 4 (Winter 1985): 813–33.

Siegan, Bernard H. *Economic Liberties and the Constitution*. Chicago: University of Chicago Press, 1980.

Tobin, James, and Wallis, W. Allen. *Welfare Programs: An Economic Appraisal*. Washington, D.C.: American Enterprise Institute, 1968.

Tumlir, Jan. *Protectionism: Trade Policy in Democratic Societies*. Washington, D.C.: American Enterprise Institute, 1985.

United States v. Butler 297 U.S. 166 (1936).

United States v. Carolene Products Co. 304 U.S. 144 (1938).

West Coast Hotel v. Parrish 300 U.S. 379 (1937).

LOSING GROUND TWO YEARS LATER

Charles Murray

Introduction

Losing Ground appeared in the fall of 1984. It was an election year, and the two presidential candidates held a debate on domestic policy. The word "black" was hardly mentioned. The "poor" were a topic, but only because of the "fairness" issue. Ronald Reagan's position was based on his proud and correct assertion that his administration was spending more on social welfare than any administration in history.

During the intervening two years, the debate on social policy has changed dramatically. Perhaps most important (at least as a first step), it is no longer necessary to defend the proposition that a problem exists. Everybody now agrees that an underclass is out there, is large, and requires attention, whereas in 1984 we were still thinking mainly in terms of people who were victimized by the economy or by other structural forces beyond their control. There is now recognition that, whereas it may be true that half the people who ever go on AFDC are off the rolls within two years, it is also true that half of all the caseload at any given time, consisting in recent years of more than 10 million adults and children, is in the midst of a spell that will last eight years or longer, and that this constitutes a serious problem of dependency (Bane and Ellwood 1983, Table 1, p. 11). There is now recognition that even in boom years, there are more than a million healthy, working-aged males, not students, who do not work a single day during the course of the year plus a few million others who are barely in the job market, and that this constitutes something more troubling than simple "unemployment."[1]

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Senior Fellow at the Manhattan Institute for Policy Research, and author of *Losing Ground: American Social Policy, 1950–1980*, one of the most influential and widely debated books on the merits and limitations of government transfers.

[1] See, for example, Bureau of Labor Statistics (1984, Tables C-17, B-17).

In 1986, unlike 1984, the problem of illegitimacy is being confronted openly. One no longer hears people talk complacently about blacks having extended families. Fewer people are saying that the two-parent family is a parochial custom of the middle class. Instead, we are now into the post-Moyers era, when it has become acceptable to recognize that when 80 percent of all live births are to single women, as they are in some poor black communities, the consequences are destructive not only for the children, not only for the single parents, but destructive of the very life of the community.[2]

In accepting that a major problem exists, the debate has changed for the better. But in other ways, the sense of déjà vu is discouraging. For example, we are now being told of a new wave of solutions. Workfare is suddenly fashionable. Liberals and conservatives are at last agreeing that people ought to perform some work in return for the assistance they receive. Child support is suddenly fashionable. Let the fathers be held accountable for the children they sire; let the parents of teenage mothers be held accountable. All around the country, state governments and localities are said to be experimenting with these bold new approaches.

I am not sure this represents progress. Putting on the evaluator's hat that I wore for most of my career, I am willing to predict what will happen. A few early successes will be documented primarily through breathless media accounts. Then the evaluations will start coming in, and it will turn out that, aside from a few Hawthorne effects, little has changed. The debunking cycle is already underway. It is being reported that Massachusetts' "ET" job placement program for AFDC mothers is not really the massive job-generator that Governor Dukakis has trumpeted, but has instead ridden the tail of a full-employment economy and may actually have slowed progress in getting welfare mothers into the labor market (see, for example, Brookes 1986 and Couch 1986). Workfare experiments in Baltimore and San Diego "are showing marked success," the *Washington Post* tells us, but the actual changes revealed by the evaluations are so marginal that they are significant only statistically (Rich 1986).

The next step of the cycle will be to examine the reasons for lack of success. The evaluators will round up the usual suspects—inadequate funding, untrained staff, problems with supervision, certain design flaws. But as attempts are made to solve these problems, it will become increasingly clear that the problems are not idiosyncratic, but built-in. There is no such thing as the error-free implementation that will finally vindicate the program concept.

---

[2] The figure of 80 percent has been reported for Central Harlem by the New York Department of Health, and Harlem is by no means a homogeneously poor community.

Worse yet, we will find once again that what we want and what we get from social programs will turn out to be mirror images. "What we want" with workfare and the rest of the new solutions is to bring people back into the mainstream of American society. We want them to become productive, independent citizens. "What we get" is a new game that we have set up for poor people. With workfare, the prize is a benefit. The state says, "To get this prize, you have to do some work unless you are exempt because of conditions A, B, and C." If he (or she) fails, and ends up having to do that work, he is doubly stigmatized. The middle-class folks drive by as he rakes leaves in the park and rejoice that at last some of those welfare loafers have to do a little work. His friends from the neighborhood drive by and laugh at him for having so little savvy, so little self-respect. Or consider child support. The child support laws being considered do not demand that the man support his child no matter what or face criminal penalties. Rather, the man will have to support his child unless he is *unable* to do so—which constitutes a looming incentive for the man to be visibly unemployed at strategic moments and to keep his visible earnings below the minimum set by the program.

I am suggesting we are about to witness a replay of the history of CETA and WIN. The government will set up a game that anyone with a little imagination and pride can beat. We will not socialize people into the world of work. We will socialize people into the world of the scam and the con.

There is also a sense of déjà vu in the optimism. The enthusiasm for the new ideas is oddly reminiscent of the early days of the War on Poverty. This time, I hear people saying, we have figured out how to do it right. What will happen when that optimism is dashed? Who will be blamed? Will the program designers finally decide that they are up against some basic misconceptions about how human beings function and about the constraints on state interventions? Will they persevere with another wave of ideas?

Because so much of the attention to the underclass has been de facto attention to the black underclass, I am concerned about still another possibility, a dangerous reaction that will see a coalition of the old racism and a virulent new kind. The old racists will see themselves confirmed in all their prejudices. When yet another set of attempts to help the poor (read, blacks) has failed, racist explanations that in recent years have been muted will become louder and more explicit. They will be augmented, in these, my worst fears, by the apologists who have for years insisted on seeing every special difficulty that blacks face as the explanation for their condition. The apologists must have *something* to blame–it cannot be the fault of their policies—and I worry that as none of the new cures work, the apologists will be increasingly attracted to a modification of the racist explanation. I see them deciding that blacks are so different from whites (for social and historical reasons, I am sure they will insist, not genetic ones) that a single standard for black and white behavior is unrealistic.[3] The current directions of the debate over social policy indicate a potential some years from now for an explosive new form of racism in this country.

The debate about social policy has indeed changed over the last two years, in some ways that I welcome, in others about which I am skeptical, and in still others that frighten me. This leads to the question of what social scientists might contribute. How can we push the dialogue along, increase our understanding of the forces at work, and perhaps eventually come to grips with the nature of real solutions. Let me suggest four themes that we should keep in mind whether we are Keynesians or classical liberals, partisans of John Rawls or Robert Nozick.

Concentrate on the White Underclass

We badly need studies of white poverty, white unemployment, white welfare recipiency, and white illegitimacy. One reason is to fill a scholarly gap—we know surprisingly little about specifically white behavior, especially compared with the extensive literature about blacks. A second reason is that whites are a much less complicated population than blacks. By looking at white dynamics, we may strip away the overlay of considerations that attach particularly to blacks. The third reason is the salutary purpose of letting whites know that the phenomena now associated with blacks are predominantly phenomena of socioeconomic class, not of race.

I have made an initial contribution to this effort by examining illegitimacy by race and socioeconomic class in the state of Ohio, the only state (to my knowledge) that publishes illegitimacy data by both race and locality.[4] To summarize the results very briefly, variance in illegitimacy rates appears to be highly lawful. Just two independent variables—percent of the population below the poverty line, and percent of the adult population with four or more years of college—explain fully 67 percent of the variance in white illegitimacy rates and 79 percent of the variance in black illegitimacy rates.[5]

---

[3] The long-term effects of affirmative action may contribute to this process, as I have argued elsewhere. See Murray (1984b).

[4] See Murray (1986). Several states publish illegitimacy data by race and county, but "county" is too large and socioeconomically heterogeneous as a unit of aggregation to be usable.

Furthermore, the strength of the relationship (as measured by the regression coefficients) was great. To put it in concrete terms, the white illegitimacy rate in affluent, highly educated Shaker Heights was less than two percent of all live births—lower than the national rate for whites in the 1940s. The white illegitimacy rate in economically depressed, ill-educated Portsmouth was 25 percent of all live births—about the same as the rates among blacks in the early 1960s that prompted Pat Moynihan (1965) to write his famous report on the breakdown of the black family.

The results from Ohio do not explain away the entire difference in black and white illegitimacy rates. Blacks and whites continue to show different baseline rates even after controlling for poverty and education. But this is only another way of saying that much work still needs to be done after far too many years in which we neglected class as an explanatory construct in our analyses of illegitimacy. Publicizing the Ohio results is a step in the right direction of turning our attention away from race and toward class-oriented explanations that so obviously deserve investigation.

Open the Black Box of Causation

The debate about *Losing Ground* has in large part been a debate about causation. How do we tease from the data what is causing what? At this point, we must concentrate on getting inside the causal black box, developing and using much better data than any that we have available now.

The nature of the problem is illustrated by the Ohio data on illegitimacy. The two independent variables—poverty and education—"explain" much of the variance, but explain not a bit of the causal dynamics. All we know is that poverty and poor education cannot be "causing" illegitimacy in any simple fashion. If they were, and this were a long-standing relationship, then illegitimacy would have been falling as the country became so rapidly less-poor and better-educated during the 1960s. "Something else" as a causal dynamic is being captured by poverty and education. What is it?

In answering such questions, social scientists have been relying too obsessively on quantitative techniques in general and the econometric tradition in particular. We must become more wary of the fallacy of the tool which says that, given a hammer, everything else becomes a nail. Given a statistical analysis package, the way to understand causation does not necessarily become numerical.

---

[5] Data refer to towns of 25,000 population or larger.

An alternative technique in exploring causation is to spend a lot more time talking to people. I am reminded of my first exposure to social science research in Thai villages nearly 20 years ago. I kept seeing researchers develop elegant survey research instruments, carefully adapted (it was thought) to the subtleties of Thai village culture—and none of them seemed to work very well. And yet, after the clipboards had been put away and we were sitting on the porch of a villager's hut talking away the evening, the same villagers would discuss the same topics intelligently, articulately, and forthrightly. Why, I asked myself, were we doing things the hard way?

We are doing things the hard way as well in our attempts to understand the complicated relationship of social policy to the behaviors of the underclass. I am not a methodological Luddite, and would not have us discard our quantitative tools nor try to imitate journalism. On the contrary, quantitative methods are uniquely powerful for answering certain questions and can be used to inform (if not resolve) almost any question. I am arguing instead for synthesis. An example of what I have in mind is suggested by the Panel Study of Income Dynamics (PSID), a longitudinal data base of immeasurable value. On the next wave of interviews for the PSID, why not hire a few good ethnologists to interview a subsample of 100 persons who were welfare-dependent in 1970, spending several hours with each respondent to capture a qualitative account of what has happened to the family during the last 16 years? It makes no difference whose theory is supported by the overall results. The diagnostic value of the individual cases is bound to be enormous. Combining the ethnographic data with nearly two decades of survey data, we would have the raw material for genuinely pathbreaking work.

A synthesis of qualitative and quantitative data would also permit us to deal with a problem that I refer to as "epistemic error."[6] Epistemic error is the gap between the construct one wishes to measure and the operational measure that is available. Consider the construct called "welfare dependency" as an example. The construct as we commonly use it has nothing to do with literal "dependency on public assistance for income." That is, we do not for most purposes wish to include the paraplegic living on a disability check as "welfare dependent," even though he is getting all of his income from the government in the form of welfare. On the other hand, it may be (though not necessarily) that a person who works full-time but lives in a subsidized apartment is importantly "welfare dependent." The referent of the construct called "welfare dependency" is a state of mind as much as it is an economic plight. "Welfare dependency" acquires its importance *as a construct* because it denotes a process whereby people of latent intelligence, imagination, and initiative are in some way debilitated because of welfare or some constellation of effects facilitated by welfare. Welfare dependency is, in other words, an extremely subtle, complex construct. To say that we are even close to capturing this construct with any of the variables we are presently using seems to me naive. I am not criticizing any particular operational definition of welfare dependency. I am saying that all are necessarily weak, and we will realize that only when we inform our quantitative data with qualitative windows on the way people live their lives.

---

[6] See Blalock (1968) and Costner (1971) for early discussions of this issue.

Let me suggest also that social scientists pay more attention to qualitative data as an exercise in humility. We are quick to dismiss the testimony of people who work in the field as "anecdotal." There are reasons to be wary of such data, it is true. But we too often go to the opposite extreme and assume that such data are worthless and that it makes no difference what a consensus of practitioners may be. If their perceptions contradict the results from our structural equation models, I have heard colleagues conclude, then it must necessarily be that the models are right and the practitioners wrong. The hubris of this attitude about the insights of practitioners is particularly misplaced among that not inconsiderable number of social scientists who have gone from kindergarten to a university faculty without ever spending more than a summer's vacation in the real world. James Q. Wilson (1983, p. 4), referring to his research experiences in the world of crime and law enforcement, once wrote that "[w]hen police officers or prosecutors refer to you as a 'sociologist,' they are not so much describing your profession as repudiating your views." It is worth our while to think about why it should be that so many practitioners in so many fields hold the views of social scientists in contempt.

Open Up the Models

The third theme is a plea to broaden the scope of our models. The behaviors we associate with the underclass are often seen in isolation. We try to explain unemployment by variables relating to the job market or we try to explain illegitimacy by variables relating to welfare, and too often run up against a dead end. A broader focus is likely to enrich our analyses. Glenn C. Loury (1986) has used the recent large-scale survey of inner-city minority youth (conducted by the National Bureau of Economic Research), one of the best and most wide-ranging of such surveys, to make this point.[7] No one thought to include in the instrument whether the young single male respondents were living with a woman and, if so, what contribution this living arrangement made to their housing, food, or cash expenses. No one thought to ask whether the single male respondents had children. A study of one of the most critical problems of the underclass, chronic male unemployment in the inner-city, failed to explore its connection with another of the most critical problems of the underclass, welfare among single inner-city mothers. Having myself designed instruments that omitted a crucial item, I can empathize with the researchers. Nonetheless, our tunnel vision is occasionally startling.

Let me take another, perhaps less obvious example of how we should broaden our models. One of the explanatory constructs for chronic unemployment is lack of "job-readiness." Another explanatory construct is "lack of education." They are seldom linked. The former is generally thought to occur because of faulty socialization by the family and peers; the latter is generally thought to contribute to unemployment via its relation to job skills. Why not construct a model and design research instruments incorporating the hypothesis that one of the inadvertent functions of education in the "old days" was socialization to the job setting? Independently of *what* you learned (which would feed into the job-skills relationship with employment), you had to "go to work" (attend classes) every day whether you felt like it or not; had to deal with the teacher as the subordinate in a strict supervisor-subordinate relationship; and had to do tedious work. You got used to the kinds of things that would, among other things, make you "job-ready." A model of the causes of chronic unemployment could make a real contribution by exploring the hypothesis that a principal consequence of the educational reforms in the 1960s and 1970s was to end, or radically diminish, the socializing function for a population of youngsters who subsequently had problems adapting to the basic requirements of a job.

Perhaps the most important new area that our models must incorporate involves what I called "status rewards" in *Losing Ground* (chap. 14). Status rewards are all the ways in which we are reinforced by the approval and respect of the community. If the community says with approval of the man with a menial job that "he takes care of his own," then having a menial job has rewards that must be measured in addition to a simple calculation of income. If the community says of the same man that he is a chump working for chump change, then a menial job has penalties that must be measured. Both the reality and the sources of these changes in status rewards urgently need investigation. We know that status rewards and penalties have enormous influence on the professional and social behavior of university faculty members. We also have a fair idea of the sources of these rewards and penalties. Why are social scientists so uninterested in the effects and dynamics of status rewards on poor people?

---

[7] See Freeman and Holzer (1984) for a summary of the findings of the NEBR study.

Rethink the Dependent Variables

The fourth and last of my themes for the reform of social science's exploration of the underclass has to do with the dependent variables we use. For the most part, we have measured "progress" in social policy according to changes in dependent variables that measure aggregate economic intake. The usual assumption has been that more money is better, regardless of its source. Thus we debate whether the poverty measure should include in-kind benefits; but hardly anyone has suggested that the poverty measure we use for the national debate ought to *exclude* all welfare, cash or in-kind. The rationale for excluding welfare income is obvious. If the national debate centered on pretransfer income, it would necessarily center as well on our progress (lack of it) in achieving the original goal of the War on Poverty, to make the working-aged dependent independent. But, except for my own plaintive remarks in *Losing Ground* (pp. 64–65), I have yet to see anyone suggest that the pretransfer measure is the crucial one.

There are also noneconomic dependent variables that deserve much higher priority. For example, if you were poor tomorrow, what would be your priorities for the reform of social policy? I do not mean your priorities if you were transformed into an illiterate inner-city black with whatever values you impute to such people; rather, what if you, with your values and attitudes were made poor. Imagine yourself an immigrant, for example, trained as a lawyer in Lithuania but forced by lack of marketable skills to sweep floors in America.

I suggest that your priorities might have very little to do with access to food stamps or to subsidized housing or to any other aspect of the income transfer system. Instead, your greatest concern might very well be safety. You would deeply resent the drug pushers in your neighborhood and the apparent inability of the police to keep them out. You would be crippled in your everyday life by the precautions you would have to take and the anxiety you would feel for your spouse and children.

You would want safety for broader reasons as well. It is difficult to interact with neighbors—to control a community and its standards, as the "good folks" otherwise naturally tend to do—if the community is fragmented by the disorganization of rampant crime. It might well be that the "social program" you most enthusiastically advocate would be the construction of a very large prison and the election of some very tough judges and prosecutors.

Another priority if you had children would likely be education. Your demands would be modest—not for more computer-aided instruction, not for a fancier gym, but for a school that teaches basic courses rigorously in an orderly atmosphere; for a school that makes good on the expectations that you instill in your children before you send them to kindergarten. It is such a simple task. For millenia, societies have known how to educate children who want to learn. We are spending more than enough to accomplish this. At the same time that policymakers worry about dropouts and delinquents—the children who for whatever reason are not ready to learn—should it not be an appropriate top priority for the reform of social policy to provide education to those whom it is so easy to educate?

I am suggesting that we define the dependent variables of social policy, the measures for assessing whether poor people are progressing or losing ground, in terms of our own values, in terms of what we would want if we were poor. This is no more revolutionary than to suggest that a large proportion of the people who live in the inner cities and in other poor communities are not members of an underclass. There is nothing broken *in them* that needs fixing. Their values and their behaviors are admirable. But they have systematically if unintentionally been punished by a social policy that has catered to other poor people who were thought to be in greater need of our help. One of the best and most practical things we can do is to provide for these citizens the same basic services that we value for ourselves. In the process, we may also—inadvertently, as seems inevitable in social policy—set in motion a reconstruction of poor communities that will do more to help members of the underclass than any "helping" program we have been able to devise.

References

Bane, Mary Jo, and Ellwood, David. "The Dynamics of Dependence: The Routes to Self-Sufficiency." Paper prepared for the assistant secretary for planning and evaluation, Department of Health and Human Services, June 1983.

Blalock, Hubert M., Jr. "The Measurement Problem: A Gap between the Languages of Theory and Research." In *Methodology in Social Research*. Edited by H. M. Blalock and A. Blalock. New York: McGraw-Hill, 1968.

Brookes, Warren. "Duped by Dukakis?" *Washington Times* (24 February 1986): D1.

Bureau of Labor Statistics. *Work Experience of the Population in 1981–82*. Bulletin 2199. Washington, D.C.: Government Printing Office, 1984.

Costner, Herbert L. "Theory, Deduction, and Rules of Correspondence." In *Causal Models in the Social Sciences*. Edited by H. M. Blalock. Chicago: Aldine, 1971.

Couch, Kenneth A. "How Good Is ET in Massachusetts?" *Washington Post* (16 March 1986): D7.

Freeman, Richard B., and Holzer, Harry J. "Young Blacks and Jobs—What We Now Know." *Public Interest* no. 78 (Winter 1984): 18–30 (to be published in Freeman and Holzer, *The Black Employment Crisis*, forthcoming).

Loury, Glenn C. Presentation at a symposium on the role of the federal government in social welfare policy. University of Michigan, 13 March 1986.

Moynihan, Daniel P. *The Negro Family: The Case for National Action*. Washington, D.C.: Department of labor, 1965.

Murray, Charles. *Losing Ground*. New York: Basic Books, 1984a.

Murray, Charles. "Affirmative Racism." *New Republic* (31 December 1984b): 18–23.

Murray, Charles. "White Families, White Welfare, 'White Trash.' " *National Review* (28 March 1986): 30–34.

Rich, Spencer. "Job Programs Aid Welfare Recipients." *Washington Post* (24 February 1986): A4.

Wilson, James Q., ed. *Crime and Public Policy*. San Francisco: ICS Press, 1983.

WELFARE DYNAMICS AND THE NATURE OF NEED

Greg J. Duncan and Saul D. Hoffman

I. Introduction

In debating welfare reform—whether to adopt a more universal scheme as proposed more than two decades ago or to move to the draconian restrictions in vogue today—it is critical to have an accurate perception of the nature of need in our society and the nature of experience with existing programs. It is, of course, the impressions gained from personal experience or colorful case studies that remain most vivid in our minds. The danger with individual cases, however, is that they may not even remotely represent the circumstances of the larger groups with which they are identified. Is Susan Sheehan's account of a three-generation welfare family in New York City in *A Welfare Mother* a depiction of the typical welfare family? Do the individuals in Ken Auletta's *Underclass* typify persistently poor people in the United States today?

When nationally representative data are used to substantiate one view or another in the welfare debate, they are typically drawn from the snapshot pictures of the status of the population provided by the Census Bureau's Current Population Surveys. Each year, the bureau selects and interviews a different set of families, gathering information about family income and poverty status, welfare use, and family structure. Analysts have placed these snapshots side by side to show aggregate changes in the number of poor families, the number of

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

Greg J. Duncan is Program Director at the University of Michigan's Survey Research Center and Saul D. Hoffman is Associate Professor of Economics at the University of Delaware. Preparation of this paper was supported in part by a grant from the Ford Foundation. Earlier drafts benefited from comments by Richard Coe, Dorothy Duncan, David Ellwood, Martha Hill, Robert Hutchens, William Prosser, Daniel Weinberg, and Doug Wolf. Neither the Ford Foundation nor any of these individuals is responsible for anything contained in this paper.

families in "latent" poverty (that is, those who would be poor had they no income from cash transfer programs), the economic conditions of families defined by characteristics such as race or female headship, and the size and composition of the welfare population.

The most interesting policy questions about the nature of poverty and the efficacy of transfer programs are dynamic, not static, and thus require a different kind of data from that provided by the Census Bureau. Turnover in the poverty and welfare populations and the duration and correlates of poverty and welfare experiences are examples of phenomena that simply cannot be addressed with cross-sectional data. The temptation to infer dynamics from static data is strong and some analysts have succumbed to it. For example, in his book *Welfare,* Martin Anderson observed that welfare benefits persistently reached about one-tenth of the nation's households, and concluded that the welfare system had "created a new caste of Americans—perhaps as much as one-tenth of this nation—a caste of people almost totally dependent upon the state, with little hope or prospect of breaking free. Perhaps we should call them the Dependent Americans" (p. 56). A moment's thought will show that evidence such as this cannot be used to demonstrate long-term dependence. Indeed, the fact that one-tenth of the nation receives welfare in two consecutive years is consistent with either no turnover in the welfare population or with complete turnover. Nothing in the data he presents justifies a conclusion about the duration of welfare experiences.

The constraints imposed by Census Bureau snapshots are clearly recognized by Charles Murray in *Losing Ground.* "What we would really like," he writes, "is a longitudinal sample of the disadvantaged" (p. 54). By longitudinal he means a study that tracks the *same* individuals and families over time.

Fortunately, the past 20 years have witnessed major investments in a number of longitudinal data projects. Best known are the Negative Income Tax experiments, with their lessons about the likely work disincentives and family structure changes that might result from changing current welfare programs to a simpler and more universal income maintenance scheme. But these samples were limited to the low-income population living in a small number of areas. Not as widely known, nor as easily grasped, are lessons about the dynamic nature of poverty and the current welfare system learned from nonexperimental data sources, in particular two of the major, nationally representative longitudinal survey projects that were begun in the late 1960s.

In this paper we focus on recent poverty and welfare research based on these nonexperimental data sets. We begin with a sketch of the dynamic nature of poverty and then summarize some of the important recent findings about the characteristics of the welfare system and the welfare population. We conclude with an assessment of the behavioral effects of welfare.

II. The Nature of Need

Census Bureau tabulations of the incidence of poverty are based on a comparison of a family's annual cash income and the annual poverty threshold applicable to that family. According to Census Bureau figures, poverty rates fell more or less continuously during the 1950s and 1960s, changed little during the 1970s, and rose sharply during the early 1980s. The relatively modest year-to-year changes in the fractions of the population who are poor are taken by many to indicate that there is little turnover in the poverty population. Indeed, the sharp recession of the early 1980s was often characterized as having added to the "old" poor a new class of the poor who had recently lost their jobs.

The Panel Study of Income Dynamics (PSID) was begun in the late 1960s in order to provide representative information on *changes* in the economic status of the population across time, as well as richer detail on factors that may account for the observed changes. The National Longitudinal Surveys (NLS) were begun at the same time with a similar design, but with a focus on labor market phenomena. Our review of the dynamic aspects of poverty focuses on data from the PSID. Evidence on welfare dynamics, reviewed in Section III below, is provided by both surveys as well as caseload records.

The simplest extension of descriptive cross-sectional information on poverty provided by Census Bureau surveys is the description of poverty patterns for a group of individuals over a fixed time period longer than a single year. Coe (1978), Hill (1981), and Duncan et al. (1984) all rely on this method and reach common conclusions:

- Movement into and out of poverty is quite widespread. Persistent poverty is by no means insignificant, but it is much smaller than single-year figures would indicate.
- In contrast to the stereotype of an urban underclass, the persistently poor are more likely to be found outside of large urban areas and include surprisingly large numbers of the elderly.

Typical poverty patterns are shown in Table 1. The time period covers 10 years, from 1969 through 1978, and poverty is determined by the official definition. Nearly one-quarter of the U.S. population is estimated to have experienced poverty in at least one year out of the 10, but only about one person in 20 was poor for most of the

TABLE 1

INCIDENCE OF SHORT- AND LONG-RUN POVERTY, 1969–78

	Percentage of U.S. Population
Poor in 1 or more years, 1969–78	24.4
Poor in 5 or more years, 1969–78	5.4
Poor, excluding cash welfare income, in 1 or more years, 1969–78	25.8
Poor, excluding cash welfare income, in 5 or more years, 1969–78	8.5

Note: "Welfare" is defined as AFDC, General Assistance and other welfare, SSI, and food stamps received by the head or wife.

SOURCE: Duncan et al. (1984, p. 163).

decade. Turnover among the poverty population is thus widespread; indeed, nearly one-third of the poor in a given year escape from poverty by the next. Bane and Ellwood (1982) have estimated that over half of all continuous poverty spells last less than three years. Even adverse macroeconomic conditions reduce turnover rates by only a few percentage points; many escape even during quite severe recessions. Of course, some of those who escape do not rise very far above the poverty line, but a surprising number do enjoy large gains.

Subtracting income from cash assistance programs produces a measure of latent poverty, consisting of individuals who would be poor in the absence of transfer programs (and also in the absence of labor market or other adjustments to the reduced income). The bottom half of Table 1 shows that without welfare income the number of individuals who would have been poor for most of the decade would have been 50 percent higher than it actually was, but the fraction of the population experiencing poverty at least once would have changed little. The targeting of assistance programs to the persistently needy produces this difference.

Some upward mobility may conform to the Horatio Alger stereotype, but a more useful view is that it often results from other kinds of labor market events and from family composition changes. Bouts of unemployment produce many short-term periods of need; but such changes in family composition as divorce or separation have even more adverse effects on the economic position of the women and children involved. But while these events produce spells of hardship, reemployment or remarriage will often produce beneficial income changes that are as large as for the detrimental events. Thus, unstable employment and family situations can create numerous situations of temporary need for a surprisingly large portion of the population.

It is possible to overstate the extent of economic mobility evidenced in these data. The *Wall Street Journal* used the evidence on mobility to counter the Catholic bishops' claim, based on single year data, that capitalism produces a very unequal distribution of income: "Under what other system do we see families so unequal at the start leaping up and crashing down, reflecting varying drives and talents?" Expanding the accounting period over which income is measured does indeed equalize the income distribution, but by less than might be expected. Hoffman and Podder (1976) found that the top fifth account for 42.3 percent of the 1973 income distribution. Averaging income over the seven-year period from 1967 to 1973 drops the share going to the top fifth only slightly—to 39.8 percent.

The numbers who do not experience upward mobility are far from insubstantial. Bane and Ellwood (1982) estimate that poverty spells for about one-sixth of the individuals who become poor last more than eight years. Duncan and Rodgers (1985) estimate that the average black child spends over 5 of his first 15 years below the poverty line; the comparable duration for white children is about 9 months. Persistent poverty is not randomly distributed among the larger group of ever-poor. Poverty among the elderly and blacks and in rural areas tends to be more persistent than among other groups and in other areas, in part because of fewer labor and marriage market alternatives.

The demographic characteristics of persistently poor individuals stand in marked contrast to those raised in discussions of the "underclass" (Corcoran et al. 1985). Although usually defined loosely by behavioral deviancy—drug addiction, mental problems, criminal activities, welfare dependence—the underclass were equated with the persistently poor by Auletta (1982). PSID data show how little overlap there is between the two groups. Most of the persistently poor live outside of large urban areas, nearly half live in families where the head is disabled, and many are beyond their early adult years (Duncan et al. 1984). This is not to minimize the potential importance of the underclass; rather it suggests that we ought not to have an underclass stereotype in mind when debating policies directed at persistent poverty.

Such facts suggest that need in our society is rather heterogeneous, with much of it temporary but some of it persistent. The dynamic characteristics of welfare receipt and the performance of the welfare system in matching these needs is the subject of the remainder of the paper.

III. Evidence on the Nature of Welfare Receipt

Inferences about turnover in the welfare rolls and the duration of welfare experiences require longitudinal information on the *same* households or welfare cases over time. As with poverty, the simplest extension of descriptive welfare information gathered in a cross-sectional survey for a single point or over a single calendar year is the description of use patterns over a fixed multiyear accounting period. Harrison (1977), Rein and Rainwater (1978), Coe (1981), and Duncan et al. (1984) all rely on this method using data from the PSID. Although each explores different aspects of welfare dynamics, two important findings are common to all of this work:

- Movement on and off of welfare rolls is widespread. Occasional welfare receipt is common; persistent welfare receipt is not.
- Annual and multiyear income "packages" of welfare families often contain more income from other sources than from welfare, with labor income being mixed with welfare income to a surprising degree.

Shown in Table 2 are patterns of receipt when the accounting period runs for 10 years, from 1969 through 1978, and "welfare" is defined as AFDC, General Assistance and other welfare, Supplemental Security Income, and the cash value of food stamps. More than one-quarter (25.2 percent) of the U.S. population is estimated to have lived in families where some form of welfare income was received in at least one year between 1969 and 1978, but only 6.5 percent of individuals lived in families that received income from welfare sources in more than half of the 10 years. These figures provide an exceedingly large bracket around the 8.1 percent of the population that is estimated to have lived in families in which welfare income was received during a single-year accounting period—1978 in this case. They suggest a great deal of turnover in the welfare rolls over fixed accounting periods, a fact confirmed by direct turnover calculations.

A second important finding of these studies is the extent of mixing of income from welfare with income from other sources. Shown in the bottom three rows of Table 2 are the corresponding fractions of the U.S. population that lived in families in which more than half of

TABLE 2

INCIDENCE OF SHORT- AND LONG-RUN WELFARE RECEIPT, 1969–1978

	Percentage of U.S. Population	Percentage of Black Children
Receiving welfare in 1 or more years, 1969–78	25.2	73.3
Receiving welfare in 6 or more years, 1969–78	6.5	42.8
Receiving welfare in 1978	8.1	—
Receiving at least 50 percent of family income from welfare in one or more years, 1969–78	8.7	45.8
Receiving at least 50 percent of family income from welfare in 6 or more years, 1969–78	2.8	16.3
Receiving at least 50 percent of family income from welfare in 1978	3.5	—

Note: "Welfare" is defined as AFDC, General Assistance and other welfare, SSI, and food stamps received by the head or wife.

SOURCE: Coe (1981, p. 163).

the total family income came from welfare sources in at least one year, in six or more years, and in 1978. All of the figures are considerably lower than the corresponding figures in the first three rows and so suggest substantial mixing of welfare income with other income over a single calendar year and over 10 years. Rein and Rainwater (1978) and Harrison (1977) examine family income "packaging" in greater detail and find that much of the nonwelfare income comes from the labor market.

The extent of welfare receipt and dependence varies widely across demographic subgroups. Black children have the highest recipiency rates: nearly three out of every four of them lived in families in which welfare was received at least once during the 10 years (Table 2, column 2). But, as with the larger population, there is a much smaller set of black children (one-sixth in all) living in families that counted heavily on welfare for most of the period.

Welfare Spells

A second approach to analyzing welfare experience with longitudinal data involves the identification of spells of welfare use, that is, contiguous months or years of welfare receipt by a household. This provides information on the distribution of completed spells of welfare use, which yields more direct evidence on whether welfare use for recipients with various demographic characteristics (age, presence of children, race, etc.) tends to be short- or long-term. It is also possible to identify the events that appear to lead to the initiation and termination of these spells. Clearly, this is information that can only be obtained from longitudinal data collected over a long period, and it is crucial for evaluating issues concerning dependence and the design of policy.

The first truly comprehensive study of welfare spells using national data was conducted by Bane and Ellwood (1983) with the PSID.[1] Since then, O'Neill et al. (1984) have analyzed the NLS and case records, and Ellwood (1985) has reanalyzed the PSID. Despite differences in the definition of a welfare spell and the use of different samples, the studies are in remarkable agreement about the duration of welfare spells. As shown in Table 3:

- A majority of welfare spells are short-term, lasting two years or less, while fewer than one-sixth can be thought of as long-term, lasting eight or more years.
- However, at any single point, half of all welfare recipients are in the midst of long-term spells.

These seemingly paradoxical findings, stressed particularly in Bane and Ellwood (1983), highlight a crucial element of welfare dynamics. The short-term nature of most welfare spells is reflected in the figures in the first four columns of the table. They are based on individuals who began welfare spells at any time between the mid-1960s and the late 1970s. They show that between one-half and two-thirds of these welfare spells lasted one or two years, and fewer than one-sixth of the spells lasted eight or more years.

Viewed in this way, it seems clear that long-term welfare receipt is relatively uncommon; it certainly does not accurately reflect the welfare experience of the majority of recipients. The fifth column presents estimates of completed spell lengths for recipients observed at a given point in time. For this group, the distribution of welfare spell lengths is nearly the opposite of that shown in the first four columns. Here, short spells characterize only one-sixth of current recipients, while half are in the midst of quite long spells, lasting eight or more years.

---

[1] Most notable among prior work are Rydell (1974), Boskin and Nold (1975), Rein and Rainwater (1978), Hutchens (1981), and Plotnick (1983).

TABLE 3

DISTRIBUTION OF LENGTH OF AFDC SPELLS AND TOTAL TIME ON WELFARE

	Distribution of Length of Spell					Total Time on Welfare[c]	
	Persons Beginning a Spell[a]				Persons on AFDC[b]	Persons Beginning a Spell[a]	Persons on AFDC[b]
			AFDC Case Records				
	PSID	NLS	1965 Cohort	1975 Cohort	PSID	PSID	PSID
1–2 Years	48	61	59	69	15	30	7
3–7 Years	35	27	25	26	36	40	28
8 or More Years	17	12	16	7	49	30	65
All	100	100	100	100	100	100	100

[a] Percent of persons beginning AFDC spell.
[b] Percent of persons on AFDC at a point in time.
[c] Includes multiple spells.

SOURCES: Cols. 1, 5–7: Ellwood (1985); cols. 2–4: O'Neill et al. (1984).

While the large difference between the ever-begun and point-in-time welfare groups may seem paradoxical, it is easily explained and, indeed, characteristic of spells of poverty and unemployment as well. It occurs because the probability of being on welfare (poverty, unemployment) at a given time is necessarily higher for longer-term recipients than for those who have shorter welfare (poverty, unemployment) spells. The point-in-time welfare sample is thus a biased sample of all welfare recipients.

An example of spells of hospitalization will help to establish this point (Bane and Ellwood 1982). Consider a 13-bed hospital in which 12 beds are occupied for an entire year by 12 chronically ill patients, while the other bed is used by 52 patients, each of whom stays exactly one week. On any given day, a hospital census would find that about 85 percent of patients (12 of the 13) were in the midst of long spells of hospitalization. Nevertheless, viewed over the course of a year, short-term use clearly dominates: Out of the 64 patients using hospital services, about 80 percent (52 of the 64) spent only one week in the hospital. Exactly the same kind of dynamics of use accounts for the results shown in columns 1–5 of Table 3. One of the most important lessons from the longitudinal evidence is that while the welfare population at any point is composed predominantly of long-term users, the typical recipient is a short-term user.

Which way of describing welfare experiences is correct? Not surprisingly, the answer depends on the nature of the question one wants to answer. On the one hand, the experience of the current population of recipients is the best guide for assessing whether short-term or long-term users account for most of the costs of the welfare system (long-term recipients do). On the other hand, for assessing the nature of welfare use, especially in the context of welfare dependency, the over-time sample is clearly the relevant one.

Spell-level analyses are also useful in showing the events that are most closely linked to the beginnings and endings of welfare receipt. Bane and Ellwood (1983) and Ellwood (1985) are again the best sources of this information; their work is used to provide the information in Table 4. A major surprise is the dominance of family composition changes over labor market events in influencing changes in welfare status. Nearly half of all AFDC spells begin with a divorce or separation; more than one-third of them end with marriage. In contrast, only about one-eighth of the spells begin with a drop in the earnings of the head of an intact female-headed household and, most surprisingly, only one in five spells ends with a major increase in labor income. O'Neill et al. (1984) found with NLS data that marriages accounted for more spell exits than any other event. This result held

TABLE 4

EVENTS ASSOCIATED WITH THE BEGINNINGS AND ENDINGS OF AFDC SPELLS

Beginnings (%)		Endings (%)	
Divorce/Separation	45	Marriage	35
Childless, unmarried woman becomes a female head with children	30	Children leave parental home	11
Earnings of female head decreased	12	Earnings of female head increased	21
Earnings of others in family decreased	3	Earnings of others in family increased	5
Other income fell	1	Transfer income increased	14
Other (including unidentified)	9	Other (including unidentified)	14
	100		100

SOURCES: "Beginnings": Bane and Ellwood (1983, p.18), using PSID data. "Endings": Ellwood (1985, p.46), using PSID data.

for both black and white women, although exits via marriage were considerably more frequent for whites. Clearly, family composition changes are more important than labor market events for much of welfare dynamics.

One potential weakness of conventional spell analysis is its emphasis on completed spells of welfare rather than on the cumulative welfare experience of individuals over time. For example, an individual could spend a high proportion of his adult years receiving welfare and yet have short welfare spells by being off welfare occasionally for a year or two. If such "recidivism" were common, the conclusion about the relatively short length of most welfare spells would need to be qualified, since what is ultimately at issue is the amount of time individuals spend on welfare and not the length of each completed spell.

The research of Bane and Ellwood (1983) and Ellwood (1985) confirms that multiple spells of welfare receipt are common. Bane and Ellwood estimate that one-third of all welfare spells are followed by subsequent spells; Ellwood estimates that 40 percent of first welfare spells are followed by subsequent spells. Allowance for multiple spells alters the distribution of welfare experiences substantially. Ellwood constructs an estimate of the total expected time on welfare for individuals first beginning a welfare spell and individuals on welfare at any given point. His estimates, shown in the final two columns of Table 3, indicate that about 30 percent of new recipients can expect to experience only one or two years of total receipt, while a similar proportion will have eight or more total years of receipt. Similarly, the point-in-time estimates are more heavily skewed toward longer-term recipients than is true for estimates (in column 5 of Table 3) based on individual spells.

Intergenerational Transmission of Welfare Dependence

There is great interest in intergenerational aspects of welfare receipt—especially whether and why children growing up in households that receive welfare may themselves be more likely to receive welfare when they establish their own households. Theories of poverty have often posited such an intergenerational component. For example, in his writings on the culture of poverty, Lewis (1968) describes a process in which children who grow up in slums absorb subcultural attitudes that prevent them from taking advantage of future opportunities.

Less frequently examined but also important are the possible beneficial effects of welfare receipt on children. Does it improve health, promote human capital investment, and, more generally, measurably equalize opportunities of lower- and higher-income children? The ideal set of data to address these questions would span two generations, and contain information about the economic position and welfare experiences of the parental household during the entire period of childhood matched with comparable information about the children during the entire time when they are raising their own children in independent households. No existing body of longitudinal data covers a sufficiently long period to provide all of this information, and retrospective information about one's parents' welfare experience cannot be recalled reliably. However, the PSID sample does contain a representative subsample of children observed first for several years as members of their parents' household and then later in their own households. It thus provides a substantial portion of the necessary intergenerational information.

In a series of articles, Hill and Ponza estimate models of intergenerational transmission of welfare receipt and dependence using 14 years of data from the PSID on young adults and their parents. The data provide yearly measures of the economic well-being, including welfare receipt, of the parental household while the children lived at home, as well as measures of the young adult's economic experiences over the period after leaving home. Observations on the parents are typically averaged over a seven-year period, as are observations on the children in their own households. The children were age 10 to 16 in 1968, the first year of the PSID study, and between the ages of 24 and 30 by 1982, the most recent year of data available to Hill and Ponza.

The transmission of welfare use was investigated by relating the young adult's welfare dependence to parental welfare dependence and a set of parental background measures such as parental education levels, number of siblings, and religion. In this case, the simple bivariate relationship between the welfare dependence of parent and child, shown in Table 5, is descriptive of the results based on more sophisticated statistical techniques. The results are surprising:

- Only a minority of black and white women growing up in heavily welfare-dependent homes are themselves heavily dependent on welfare in their own households.
- For black women, there is no significant link at all between the welfare dependence of parent and child.

The table shows that only 19 percent of this representative sample of black women coming from highly welfare-dependent parental homes were themselves observed to be heavily dependent on welfare when they had established independent households, while an additional 39 percent received some welfare income, but not more than one-quarter of family income. Most remarkable is that the 19 percent figure is not very different from the comparable fraction (14 percent) of black women coming from households that received no welfare. In fact, the regression models showed no statistically significant effects among blacks of parents' welfare dependence on their children's likelihood of welfare dependence. The only evidence of welfare dependence transmission was observed for whites, and then only for very high levels of parental welfare dependence, based on a small number of observations, and with effects that were not consistent across all models tested.

By relating the work hours of young men to measures of parental welfare receipt, Hill and Ponza also explored the links between parental welfare background and the labor supply of young men. They found that welfare receipt had no significant effect on the work hours of black men. However, white men coming from parental homes with heavy dependence on welfare averaged seven fewer hours of work per week than did otherwise similar white men.

In sum, there was no evidence of statistically significant links among blacks between welfare receipt by parents and either welfare receipt or labor supply of children once they had established their own households. Possible links exist for whites, but only for the quite

TABLE 5

INTERGENERATIONAL TRANSMISSION OF WELFARE DEPENDENCE

	Status of Daughters as Young Adults				
Parental Welfare Status	Received No Welfare(%)	Low Welfare Dependence(%)	High Welfare Dependence(%)	Total	Number of Observations
Received no welfare					
Black	53	33	14	100	108
White	79	19	2	100	354
Low welfare dependence					
Black	31	49	20	100	130
White	63	31	5	100	75
High welfare dependence					
Black	42	39	19	100	92
White	27	47	26	100	25

Note: "High Welfare Dependence" is defined as receiving at least 25 percent of average family income as cash welfare payments. Parental measures are typically averaged over seven years during the time the child is 10–16 years old. Measures on the children as young adults are typically measured over seven years during the time the child is 24–30 years old.

SOURCE: Hill and Ponza (1984), using PSID data.

small fraction of white children coming from the most heavily dependent families.

IV. The Behavioral Effects of the Welfare System

The findings reported in the previous section of this paper provide a consistent, if still little known, view of the welfare system and of welfare usage. There are four key findings in that view: the preponderance of short-term usage of the welfare system, the substantial extent to which receipt of welfare income alternates or is mixed with income from other sources, the importance of demographic events in affecting entries into and exits from welfare, and the absence of an intergenerational transmission of welfare status.

Moreover, it appears that welfare programs and funds are fairly well-targeted on the most needy. One indication of this is the high fraction of total AFDC program resources that go to long-term recipients. Because, as explained earlier, long-term recipients always comprise a majority of current recipients, they naturally receive a majority of benefits. Ellwood (1985) estimated that 24 percent of all welfare recipients accounted for 56 percent of all person-years of welfare use and received a corresponding share of all benefits.

Duncan et al. (1984) found that of individuals who would have been persistently poor over a 10-year period in the absence of welfare benefits, almost 97 percent received some benefits and more than 84 percent received benefits more than half the time. Only about 5 percent of the temporarily poor individuals received benefits during more than half the period and virtually none (0.4 percent) of the individuals who lived in families with pre-transfer incomes *above* the poverty line for the entire period received benefits for more than half the period.

The generosity of the programs—the extent to which program benefits lifted needy individuals above the poverty line during periods of receipt—is a different matter. Here the evidence indicates that transfer programs leave many of those who were persistently poor in the absence of benefits still poor even after the receipt of benefits (Duncan et al. 1984). A flavor of the evidence can be obtained by comparing the actual and latent poverty rates presented in Table 1. About two-thirds of the individuals who would have been poor in the absence of transfers for at least 5 of the 10 years were in fact still poor for a comparable period when program benefits had been added to their incomes.

Although this descriptive evidence provides substantial support for a benign view of how the welfare system operates for the majority of recipients, it has one important weakness. To assess the welfare system adequately, one needs to go beyond descriptive evidence on patterns of usage and consider the possible effects of the welfare system on the behavior of individuals, especially on the minority of long-term recipients. Consider, for example, the finding in Table 4 that 75 percent of all welfare spells begin following a divorce, separation, or out-of-wedlock birth. If one views those demographic events themselves as unaffected by the operation of the welfare system, then the welfare system might be regarded as a kind of insurance system, usually providing assistance to individuals facing temporary misfortune. But if those events are endogenous—that is, increased by the availability or generosity of welfare—one would want to draw a quite different conclusion, especially if the impact were substantial. The same point can be made about the extent to which welfare reduces "latent poverty," if, as Murray and others have argued, the availability of welfare increases latent poverty in the first place.

Perverse behavioral effects are at the crux of the argument that the welfare system is a cause of rather than a cure for poverty. There appear to be two general kinds of concerns: (1) that the existence of a welfare system encourages a class of undesirable individual behavior that substantially increases pre-transfer need; and (2) that receipt of welfare is in itself harmful in that it creates dependence and discourages self-sufficiency. The first category includes two separate kinds of effects: the potentially adverse effect of welfare on labor supply as well as its possible impact on divorce, marriage, childbearing, and living arrangements. The second category is less clearly defined, but presumably implies that welfare receipt has a destructive effect on personal values and attitudes.

In the rest of this section, we examine the current evidence on the potential negative impact of the welfare system on behavior. We begin with the one issue on which there is fairly good evidence: the labor supply effect of welfare. We then turn to the family structure issue, and conclude with an examination of the dependence problem.

Welfare and Labor Supply

The desire to provide low income families with an adequate standard of living, and yet to limit welfare benefits to the most needy, typically makes it necessary to impose high benefit reduction rates. This, as economists have pointed out at least since the early 1960s, is equivalent to a high rate of taxation on earned income, especially as compared with the tax rates that face low income families in the positive income tax system. Compared with the situation they would face in a world without welfare, welfare recipients have both a higher gross income and a much lower wage rate, both of which are expected to reduce labor supply.

There are two kinds of evidence to use in evaluating this work disincentive effect. One comes from annual surveys of AFDC recipients, which typically show that only a small fraction of women receiving AFDC are currently employed. For instance, in March 1983 less than 6 percent of AFDC recipients were employed, down sharply from over 15 percent a decade ago (Ruggles 1985). While this may seem to suggest an enormous labor supply effect, such a conclusion is unwarranted without evidence on what the labor supply of these women would have been in the absence of AFDC. In view of the typically low educational level and job skills of many welfare recipients as well as the presence of young children in many welfare households, it is not clear that the labor supply of these women would have been very large in any event. In addition, as pointed out in Section III, recipients appear to alternate frequently between income from work and welfare, and the periods of welfare receipt may be caused by the unavailability of work.

More helpful in assessing the likely labor supply effects of welfare are the results of the Negative Income Tax experiments. While these experiments were designed primarily to examine the effects of extending welfare benefits to intact families, the labor supply results provide estimates of structural labor supply parameters that can be used to infer the likely impact of the current system on labor supply. Robins (1985) reports consensus findings from the various NIT experiments. For female heads, the estimated annual labor supply falls by 78 hours for each one dollar wage reduction caused by the higher welfare tax rate and falls by 55 hours per each $1000 increase in annual income. Therefore, a woman whose wage was decreased by $2.50 an hour and whose net income was increased by $2000 per year would, on account of these welfare-induced changes, reduce her work hours by about 305 hours per year.

To predict the actual labor supply impact requires information on the exact wage and income changes for each eligible woman. Keeley et al. (1978) used such information to make labor supply estimates of hypothetical welfare programs with different levels of generosity. For example, for a relatively generous program (maximum benefits equal to the poverty level and a 70 percent benefit reduction rate), they estimated that the annual labor supply of those female heads who chose to receive welfare would fall by about 15 percent on average. The labor supply effects for less generous programs were somewhat smaller than that.

This estimate is far from insignificant, but also substantially less than might be inferred if one assumed that current recipients would otherwise be full-time workers. Additional evidence from the NIT experiments suggests a relatively modest (5 percent) labor supply reduction for husbands if intact families were made eligible for assistance.

Welfare and Family Structure

The argument that AFDC affects family structure is quite simple and, indeed, it is among the oldest criticisms of a welfare system that predicates assistance on categorical status. By raising the income available to a single woman with dependent children but not to intact families or a single woman without children, AFDC is alleged to encourage marital instability, illegitimate births, and the establishing of independent households by unmarried mothers, while discouraging marriage and remarriage. This hypothesis is unquestionably plausible, and it is broadly consistent with aggregate time trends that show an increase in the percentage of female-headed families as a consequence of rising rates of divorce and falling rates of marriage (Bane and Ellwood 1984).

More detailed individual-level studies of various family structure decisions have, however, failed to find consistent empirical evidence that the welfare system plays an important role in these decisions. The issue has been extensively studied for over a decade, producing some scattered evidence of AFDC effects on some family structure decisions but with many studies failing to find an impact (Bishop 1980). And in no case are the estimated effects large enough to account for very much of the time-series trends in divorce, illegitimacy, or female headship rates.

The best, most comprehensive, and most recent work on this topic is by Ellwood and Bane (1984). They examine a lengthy list of family structure variables and do find some evidence of AFDC effects. In their research, AFDC had no measurable impact on births to unmarried women and only a modest effect on divorce or separation as well as on female headship rates. Its biggest impact was on the living arrangements of single mothers; they found that young mothers not living with a husband were more likely to live independently rather than in the home of a parent in states with high AFDC benefit levels. They concluded that "the more significant the family structure or living arrangement change, the less influence AFDC seems to have." More generally, though, they concluded that welfare was not the primary cause of variation in family structure across states or over time and that, instead, this variation reflected "largely unmeasurable differences in culture, attitudes or expectations."

Our own opinion on this issue is ambivalent. On the one hand, the evidence in support of substantial AFDC effects on family structure is, on the whole, relatively weak. On the other hand, our own work in this area has convinced us that this entire body of research, including the Ellwood and Bane study, has been poorly specified and that the results are therefore suspect. Simply put, the problem is that researchers have failed to pay adequate attention to the behavior of individuals and the way in which that behavior might be affected by the welfare system. Although individuals are presumed to be choosing among alternatives (for example, marriage vs. single headship vs. AFDC receipt), the actual characteristics of the alternatives available to an individual have not been adequately identified in empirical work. Not only have the details of the welfare system as they affect an individual been crudely specified, but also—and much more seriously—the nature of the nonwelfare alternatives available to women has been largely ignored (as pointed out in Wilson and Neckerman 1984).

The result is that the studies are a crude and potentially misleading test of the hypotheses at issue. We do not yet know whether the weak research findings are the consequence of the weakness of the research methodology or reflect the true effects of the welfare system. Further research here is critical.

Does Welfare Receipt Cause Dependence?

The patterns of welfare receipt described in Section III clearly allay the concern that any brush with the welfare system necessarily leads to dependence. Most spells of welfare use are of relatively short duration and most recipients mix or alternate between income from work and welfare. Even accounting for repeat spells, half of all welfare recipients spend less than four years of their life on welfare. Furthermore, most children raised in heavily dependent homes do not themselves become dependent adults.

Still, Ellwood estimates that about 30 percent of all individuals who ever begin welfare spells will spend eight or more years on welfare (not necessarily consecutive and not necessarily receiving the majority of their income from welfare) during their prime working years. Thus, while welfare support does not appear to lead to long-term dependence for most individuals who ever receive it, there is a far from insignificant number of adults and children in the United States, at least several million, who live in families that could be described as dependent on welfare. As shown in Table 2, one-sixth of all black children live in households that depend heavily on welfare.

What is not yet clear, however, is whether the welfare system is itself the cause of this dependence. A pattern of relatively continuous welfare use may indeed be the result of a causal process in which initial receipt produces changes in attitudes or behavior that make subsequent receipt more likely. Alternatively, that pattern of receipt may reflect the permanent characteristics of an individual (including such measured traits as disability status or education and unmeasured values and attitudes), which are the cause of both the beginning of a spell of welfare and its continuation. In this instance, the actual receipt of welfare has little or no independent effect on the length of receipt.

Statisticians obfuscate these phenomena with the terms "state dependence" and "heterogeneity," respectively, and distinguishing between them in empirical work is extremely difficult. It is not enough to observe that some welfare recipients receive benefits for many years or that receipt at one time is correlated with subsequent receipt. Such evidence is consistent with either or both explanations.

Thus far, the evidence for the state dependence explanation is relatively weak (Plant 1985). Implicit in that argument is the idea that contact with welfare causes some behavior or attitudes to change, whereas the heterogeneity explanation assumes that unchanging characteristics are crucial and that welfare plays no causal role. Thus, potential tests would involve identifying some set of attitudes that are changed in welfare recipients by the receipt of welfare. But no such changes have been successfully identified in empirical work. O'Neill et al. (1984) examined the possible links between AFDC receipt and measures of personal efficacy and future orientation to assess whether welfare had a negative impact on those measures. Although other studies (Andrisani 1978; Hill et al. 1985) have found that wage and employment changes affected these measures, welfare receipt did not prove to have an impact. O'Neill et al. concluded that there was "nothing to indicate that experience with AFDC causes significant changes in personal efficacy" (p. 87).

The substantial evidence that most welfare use is short term suggests strongly that whatever dependence effect welfare may possess is relatively weak. Furthermore, as noted in Section III, welfare usage does not appear to be transmitted from one generation to another. If welfare receipt had a strong behavioral effect, an intergenerational effect would be likely. While it is possible that further research will uncover a causal link between current welfare usage and future usage, such a relationship has not thus far been established.

Does Welfare Help Children?

Discussions of the intergenerational aspects of welfare receipt have rarely progressed beyond the negative issues of whether welfare dependency is passed on from one generation to the next. Since welfare benefits are presumed to be—at least in part—investments in the children living in recipient households, it is important to assess the extent to which parental income in general and welfare income in particular are linked to the positive attainments of children, such as schooling and earnings in adulthood.

Despite the existence of appropriate intergenerational data from the PSID, to our knowledge there have been no studies of this issue. More general studies of the role of parental income on the attainment of children (Sewell and Hauser 1975; Jencks et al. 1979) have found significant such links, even after controlling for parental education and occupational status. Several studies have found that parental income accounts for many of the detrimental effects of growing up in a single-parent household (Hill 1985; McLanahan 1983). But none of these studies has attempted to estimate the role of welfare income as such in the intergenerational attainment process, taking into account both the income augmentation and stabilization functions of welfare programs plus the possible negative effects of growing up in a welfare-dependent home. This topic is also an important one for the future welfare research agenda, which needs to address both positive and negative consequences of welfare.

V. Summary

Dynamic evidence on the nature of need and welfare experiences shows that a surprisingly large proportion of poverty and welfare spells are only short-lived. Although the number of persistently poor or persistently dependent families is far from insignificant, the more typical situation is one of temporary need, caused by a bout of unemployment, a divorce, or similar labor market or family event. Many of the temporarily needy do not use the welfare system at all, and those who do usually receive welfare for relatively short periods. Welfare recipients often alternate between welfare receipt and work, and most children growing up in heavily dependent homes do not become heavily dependent when they establish their own households. Taken together, this evidence suggests that the welfare system functions fairly well for the majority of recipients as insurance against temporary misfortune.

While they constitute a minority of all recipients, the fact that several million individuals are persistently dependent on welfare raises questions of whether welfare itself promotes divorce or out-of-wedlock births, discourages marriage or instills counterproductive attitudes and values in recipients. Sparse evidence on the effects of welfare on the attitudes of recipients fails to show any such links. Whether welfare affects family decisions is, in our view, an unresolved question at this point.

Further research is needed to determine whether welfare has a significant impact on dependence. Another important question for future research is whether welfare measurably improves the economic opportunities of children in recipient families. The evidence available at this point, however, does not support the view that Great Society welfare programs have hurt rather than helped poor people. That view, based solely on cross-sectional evidence, is simply not compatible with longitudinal evidence showing the benign nature of most contact with welfare.

References

Anderson, Martin. *Welfare*. Stanford, Calif.: Hoover Institute Press, 1978.

Andrisani, Paul J. *Work Attitudes and Labor Market Experience*. New York: Praeger, 1978.

Auletta, Kenneth. *The Underclass*. New York: Random House, 1982.

Bane, Mary Jo, and Ellwood, David. "Slipping Into and Out of Poverty: The Dynamics of Spells." Working Paper, Harvard University, Kennedy School of Government, 1982.

Bane, Mary Jo, and Ellwood, David. "The Dynamics of Dependence and the Routes to Self-Sufficiency." Final Report to the U.S. Department of Health and Human Services. Cambridge: Harvard University, Kennedy School of Government, 1983.

Bane, Mary Jo, and Ellwood, David T. "The Dynamics of Children's Living Arrangements." Harvard University, 1984. Mimeo.

Bishop, John H. "Jobs, Cash Transfers and Marital Instability: A Review and Synthesis of the Evidence." *Journal of Human Resources* 15 (Summer 1980): 301–34.

Boskin, M., and Nold, F. "A Markov Model of Turnover in Aid to Families with Dependent Children." *Journal of Human Resources* 10 (1975): 507–81.

Coe, Richard D. "Dependency and Poverty in the Short and Long Run." In *Five Thousand American Families: Patterns of Economic Progress*, vol. 6. Edited by Greg J. Duncan and James N. Morgan. Ann Arbor: Institute for Social Research, 1978.

Coe, Richard D. "A Preliminary Empirical Examination of the Dynamics of Welfare Use." In *Five Thousand American Families: Patterns of Economic Progress*, vol. 8. Edited by Greg J. Duncan and James N. Morgan. Ann Arbor: Institute for Social Research, 1981.

Corcoran, Mary et al. "Myth and Reality: The Causes and Persistence of Poverty." *Journal of Policy Analysis and Management* 4 (1985): 516–37.

Duncan, Greg J. et al. *Years of Poverty, Years of Plenty.* Ann Arbor: Institute for Social Research, 1984.

Duncan, Greg J., and Rodgers, Willard L. "The Prevalence of Childhood Poverty." Survey Research Center, University of Michigan, 1985. Mimeo.

Ellwood, David T. "Targeting the Would-be Long Term Recipient of AFDC: Who Should Be Served?" Harvard University, 1985.

Ellwood, David T., and Bane, Mary Jo. "The Impact of AFDC on Family Structure and Living Arrangements." Report to the U.S. Department of Health and Human Services, Harvard University, 1984.

Harrison, Bennett. "Labor Market Structure and the Relationship Between Work and Welfare." Department of Urban Studies and Planning, MIT, 1977. Mimeo.

Hill, Martha S. "Some Dynamic Aspects of Poverty." In *Five Thousand American Families: Patterns of Progress,* vol. 9. Edited by M. Hill, D. Hill, and J. Morgan. Ann Arbor: Institute for Social Research, 1981.

Hill, Martha S. "The Impact of Parental Marital Disruption on the Socioeconomic Attainments of Children As Adults." Ann Arbor: Institute for Social Research, 1985. Mimeo.

Hill, Martha S., and Ponza, Michael. "Poverty Across Generations: Is Welfare Dependency A Pathology Passed on from One Generation to the Next?" Paper presented at the Population Association of America meetings, 1983.

Hill, Martha S., and Ponza, Michael. "Does Welfare Dependency Beget Dependency?" Institute for Social Research, Fall 1984. Mimeo.

Hill, Martha S. et al. "Motivation and Economic Mobility of the Poor." ISR Research Report. Ann Arbor: Institute for Social Research, 1985.

Hoffman, Saul D., and Podder, Nripesh. "Income Inequality." In *Five Thousand American Families: Patterns of Progress,* vol. 4. Edited by Greg J. Duncan and James N. Morgan. Ann Arbor: Institute for Social Research, 1976.

Hutchens, Robert M. "Entry and Exit Transitions in a Government Transfer Program: The Case of Aid to Families with Dependent Children." *Journal of Human Resources* 16 (Spring 1981): 217–37.

Jencks, Christopher et al. *Who Gets Ahead: The Determinants of Economic Success in America.* New York: Basic Books, 1979.

Keeley, Michael C. et al. "The Labor Supply Effects and Costs of Alternative Negative Income Tax Programs." *Journal of Human Resources* 13 (Winter 1978): 3–36.

Lewis, Oscar. *La Vida, A Puerto Rican Family in the Culture of Poverty. San Juan and New York.* London: Panther Books, 1968.

McLanahan, Sara. "Family Structure and the Reproduction of Poverty." Institute for Research on Poverty Discussion Paper, Madison, Wis., 1983.

Murray, Charles. *Losing Ground.* New York: Basic Books, 1984.

O'Neill, June A. et al. "An Analysis of Time on Welfare." Report to ASPE/Department of Health and Human Services. Washington, D.C.: Urban Institute, June 1984.

Plant, Mark W. "An Empirical Analysis of Welfare Dependence." *American Economic Review* 74 (September 1984): 673–84.

Plotnick, Robert. "Turnover in the AFDC Population: An Event History Analysis." *Journal of Human Resources* 18 (Winter 1983): 65–81.

Rein, Martin, and Rainwater, Lee. "Patterns of Welfare Use." *Social Service Review* 52 (December 1978): 511–34.

Robins, Philip K. "A Comparison of the Labor Supply Findings From the Four Negative Income Tax Experiments." *Journal of Human Resources* 20 (Fall 1985): 567–82.

Ruggles, Patricia. "Changes in Assistance Programs Over Time: Are Income Support Programs Losing Their Sensitivity to Changes in Economic Circumstances?" Urban Institute, 1985. Mimeo.

Rydell, C. Peter et al. *Welfare Caseload Dynamics in New York City.* New York: Rand Corporation, 1974.

Sewell, William H., and Hauser, Robert M. *Education, Occupation and Earnings*. New York: Academic Press, 1975.

Sheehan, Susan. *A Welfare Mother.* Boston: Houghton-Mifflin, 1976.

Wall Street Journal. "Rich Man, Poor Man" (editorial), 28 November 1984.

Wilson, William J., and Neckerman, Katherine M. "Poverty and Family Structure: The Widening Gap Between Evidence and Public Policy Issues." Paper presented at conference on Poverty and Policy: Retrospect and Prospects, Williamsburg, Va., 1984.

TRANSFERS AND POVERTY: CAUSE AND/OR EFFECT?

June O'Neill

Recently there has been a resurgence of concern about high levels of poverty in the United States. At the same time attention has been focused on the growth of the public transfer sector. Although the two developments have been linked, different commentators have reached quite opposite conclusions. Authors such as Harrington (1984) maintain that welfare spending has not been adequate to address the problem. Others, however, have pointed to the transfer system itself as the source of the problem. Murray (1984) has stressed the disincentives for work and marriage created by the welfare system, which "made it profitable for the poor to behave in the short term in ways that were destructive in the long term." Gallaway, Vedder, and Foster (1985) have taken this argument a step farther and argue that the disincentives are so strong that poverty is directly increased as transfers rise, once the level of benefits reaches a certain threshold.

This paper discusses the growth in transfer programs and its relation to poverty, family structure, and work effort. Since almost everyone concedes that the state of the economy influences the poverty rate, this paper begins with a brief review of the poverty statistics and their relation to economic trends and fluctuations, and then examines the effect of expenditures on the trend in poverty. It is concluded that economic growth and the business cycle are major determinants of the change in poverty, while the role of transfers is more difficult to establish.

The next section discusses the relation between transfers and poverty, focusing on one particular program—Aid to Families with

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Assistant Staff Director for Programs and Policy at the U.S. Commission on Civil Rights. The views expressed are solely those of the author and do not necessarily represent those of the Commission.

Dependent Children (AFDC). It is likely that the increase in female-headed families has been influenced by welfare as well as by the rise in women's labor market opportunities. Although welfare alleviates poverty in the short term it may in the long run foster dependency and impede the upward mobility of families.

Poverty and the Economy

Between 1979 and 1983 the poverty rate rose from 11.7 percent to 15.3 percent (Table 1).[1] This development has undoubtedly motivated the current concern about poverty. The recent rise in poverty is no mystery, however. It was brought on by the deep recession that started in 1979—a recession marked by a decline in productivity and a sharp rise in unemployment. The real income of the average American male was lower in 1983 than in 1979; it should therefore come as no surprise that the income of those at the lowest portion of the income distribution also fell, resulting in a rise in poverty.

The relation between the economy and poverty is long-standing. It was basically the remarkably high rate of economic growth during the 1950s and 1960s that caused the poverty rate to decline by close to two-thirds over the post–World War II period. Then, during the period of economic stagnation of the late 1970s, the poverty rate stopped falling. In other words, the rising tide lifts all boats, but first there must be a rising tide.

Social Welfare Spending

In principle it would seem that the government should be able to reduce the number of people in poverty, regardless of the state of the economy, by taxing those who are well-off and giving the revenue to the poor. The appeal of this seemingly straightforward solution has undoubtedly influenced the growth in transfers over the past two decades. Broadly defined, publicly funded social welfare expenditures

---

[1] The rise in the poverty rate over this period may be overestimated due to mismeasurement of inflation. As Weicher (1986) notes, until 1983 the Consumer Price Index gave a large weight to the mortgage interest rate, which is a cost faced only by the small percentage of homeowners who finance their homes in the given year. The CPI now uses a rental equivalency measure for homeownership. However, the new method was not used to change the official CPI before 1983, although it had been estimated for prior years. Weicher has reworked the poverty data using the alternative CPI for years before 1983 (see Table 1). His adjusted rate rises from 10.5 percent in 1979 to 13.3 percent in 1983—a rise of 2.8 percentage points, which is lower than the rise of 3.6 percentage points indicated by the official poverty rate.

TABLE 1

TRENDS IN UNEMPLOYMENT, REAL INCOME, AND POVERTY

		Median Income (Thousands of 1984 Dollars)		Poverty Rate		
Year	Civilian Unemployment Rate (1)	All Men (2)	Men Working Full-time Year Round (3)	Official Rate (4)	Weicher Adjustment (5)	Adjusted for In-Kind Benefits[a] (6)
1949	5.9	10.2	—	33.0[b]	—	—
1959	5.5	14.2	18.7	22.4	—	—
1969	3.5	18.2	24.6	12.1	11.8	—
1973	4.9	18.8	26.8	11.1	10.7	—
1975	8.5	17.1	25.0	12.3	11.5	—
1979	5.8	16.9	25.0	11.7	10.5	6.8
1980	7.1	15.8	24.2	13.0	11.5	7.9
1981	7.6	15.4	23.6	14.0	12.2	9.0
1982	9.7	15.0	23.3	15.0	13.2	10.0
1983	9.6	15.3	23.5	15.3	13.3	10.3
1984	7.5	15.6	24.0	14.4	12.6	9.7

[a] Noncash benefits measured by market value.

[b] Estimated rate.

SOURCES: For columns 1–4, Council of Economic Advisers (1986), Statistical Appendix, Tables B-29 and B-31; for column 5, Weicher (1986); for column 6, U.S. Bureau of the Census (1985).

increased from 11 percent of GNP to 19 percent over the period 1965 to 1983.[2]

There are several reasons why this massive change in the transfer system has not reduced poverty to the extent expected. One reason is that many of these transfers were not directed exclusively at poor people. The social insurance programs (including Social Security, medicare, public employee retirement, and unemployment compensation) make up more than half of all social welfare expenditures. These programs are intended to replace a significant fraction of income during retirement or unemployment. While the poor also benefit from these programs, the largest benefits go to those with higher incomes.[3]

Although the huge expansion in Social Security was costly and could be judged an inefficient way to reduce poverty among the elderly, it does appear to have contributed to the large reduction in poverty for this particular group. The poverty rate for persons 65 and older declined from 25 percent in 1969 to 15 percent in 1979, while the rate for all persons edged down only four-tenths of a percentage point. This was a stagnant period for the economy, but the average Social Security benefit rose by about 35 percent in real terms.[4]

The growth in a subset of social welfare expenditures targeted on low-income individuals (that is, a means test is required) is shown in Table 2. These programs rose from 1 percent of GNP in 1965 to about 3 percent in 1975 and have remained roughly at that level.

A second reason why transfers have not had a greater effect on the overall poverty rate is that a growing share of all transfers is given in the form of noncash benefits (such as food stamps and medical care) that are not counted as income for the purpose of measuring the official poverty rate. The Census Bureau, however, now provides estimates of the poverty rate based on a definition of income that

---

[2] This is based on the definition and estimates made by the Social Security Administration. See *Social Security Bulletin* 49 (February 1986).

[3] Benefits are related by formula to past earnings, and although the "replacement rate" falls as lifetime earnings rise it is still the case that the highest earners receive the largest benefits. High earners, of course, have paid in higher taxes. Note too that many of the very poorest do not receive benefits because they do not have a history of covered earnings (or a spouse with covered earnings).

[4] The poverty rate for those aged 65 and older actually fell between 1979 and 1984 by 2.8 percentage points, while the overall rate rose by almost the same amount. This decline in poverty for the elderly may be related to high interest rates, since the elderly have greater saving than others. Social Security benefits were increased with the price level, but this was not a period of real increases in Social Security. Therefore, Social Security is not likely to have been the source of decline in the poverty rate of the elderly during this period.

TABLE 2

MEANS-TESTED PUBLIC WELFARE EXPENDITURES (BILLIONS OF 1984 DOLLARS)

Fiscal Year	Cash Benefits[a]	In-Kind Benefits[b]	Total	Total as % of GNP
1960	12.4	5.1	17.5	1.0
1965	14.8	10.6	25.4	1.1
1970	24.7	27.7	52.4	1.0
1975	33.4	56.2	89.6	2.9
1979	31.1	75.3	106.4	3.0
1981	29.7	76.4	106.1	3.1
1983	29.8	73.0	102.8	3.0

[a] Categorical cash payment programs including AFDC, supplemental security income, and general assistance.

[b] Includes medicaid, food stamps, maternal and child health programs, child nutrition programs, other food programs, low-income energy assistance program, and certain social service and work-experience programs.

SOURCE: *Social Security Bulletin* 49 (February 1986).

includes an estimated value of noncash benefits. In 1984 this adjusted poverty rate (in which noncash benefits were measured by their market value) was 9.7 percent compared with the unadjusted "official" rate of 14.4 percent. Moreover, the Census Bureau's estimate misses a significant amount of noncash benefits. Based on reported program data I estimate that about $41 billion in noncash benefits targeted on low income individuals was unreported in 1984. (Cash welfare benefits also are significantly underreported.)

A third and more substantive reason why transfers do not reduce poverty as much as expected is that the transfers themselves have offsetting effects. A dollar of benefits does not simply add a dollar to a needy person's income, since it creates incentives for other people to change their behavior in order to qualify. For example, in the case of the Social Security programs, early retirement has undoubtedly been encouraged by sharply rising benefit levels. In 1948, 47 percent of men 65 years and over were in the labor force; in 1984 their labor force participation rate was 16 percent. Retirement benefits were extended to men aged 62 to 64 in 1961. In 1960 the labor force participation rate of men aged 60 to 64 was 78 percent—a level that held for the two previous decades. By 1975 the rate for this group had fallen to 66 percent. Similarly, the expansion of the disability program is linked to a substantial reduction in labor force activity among the disabled.[5]

[5] Current population survey data show that an increasing proportion of men, particularly

Thus the earnings or pretransfer income of the elderly is not a good measure of their need: without the transfer, a much larger proportion would be working and their earned incomes would be higher. The true poverty-reducing effect of Social Security can only be honestly estimated if account is taken of the offsetting work disincentive effect. This is a difficult measurement problem because behavior changes over a period of time in response to a benefit change as well as to changes in other factors.

Empirical Evidence from Time Series

Several studies have tried to estimate the effect of both transfers and economic factors on poverty using time series analysis. The results of studies by different researchers are shown in Table 3. They are hardly conclusive. In fact, one conclusion to be drawn from these results is that time series analysis is a slippery business.

Gottschalk and Danziger (1984) present several equations estimating the determinants of poverty, where the equations differ in the way the variables are defined and in the time period considered. In most cases they find that an increase in transfer payments is associated with a reduction in poverty. But in some equations they find no significant effect of transfers. The variables intended to measure economic growth and cyclical fluctuations do not always have the expected effects either. The problem is that, over time, many variables are correlated with each other, and as a result, their independent effects are difficult to discern. The startling finding of the study by Gallaway, Vedder, and Foster (1985)—that transfers reduce poverty only up to a threshold level (attained in 1971) beyond which they *increase* poverty—may simply reflect time series intercorrelations.

Changes in the definition of a variable can have a significant effect on the outcomes of the analyses. The measurement of transfer payments is a case in point. In the Gallaway-Vedder-Foster paper, transfers are measured inclusive of in-kind benefits, while the Gottschalk-Danziger paper limits transfers to cash benefits.[6]

---

at older ages, reported that they are out of the labor force due to disability during the late 1960s and early 1970s, when disability benefits were rising. This is consistent with the expansion of the disability program caseloads. It is unlikely that these patterns could be explained by a spontaneous increase in the incidence of disability in the population. Parsons (1980) and Leonard (1979) also analyze the effect of disability on labor force participation.

[6] The income and unemployment variable used in the two studies also differs. Gallaway, Vedder, and Foster use national income per capita, and Gottschalk and Danziger use GNP per household in some equations and median family income in others. Neither variable is a good measure of productivity or wage increases (see O'Neill 1984).

TABLE 3

POVERTY RATE REGRESSIONS USING ALTERNATIVE SPECIFICATIONS OF THE MODEL

	Gottschalk and Danziger				Gallaway et al.	
Regressors	1949–82	1966–82			Regressors	1953–83
Time	−.16 (3.1)[a]	−.57 (25.0)			Wage Rate	.79 (3.73)
Time^2	.001 (2.9)	.004 (26.3)			GNP Deflator	−.83 (3.41)
Log Real GNP per Household			−.09 (.1)		Productivity	−.49 (5.07)
Log Real Median Family Income				−1.7 (6.0)	Real National Income per Capita	−.14 (3.74)
Log Unemployment	.17 (4.2)	.30 (21.5)	.31 (1.9)	.04 (.6)	Aid[b]	−.0577 (2.28)
Log Real Cash Transfer per Household	−.17 (1.0)	−.25 (5.5)	−.51 (1.6)	.06 (.5)	Aid^2	.00026 (3.17)
R^2	.97	.99	.97	.99	R^2	.98

[a] The t-statistics are in parentheses.

[b] Federal public aid per capita, as defined in *Social Security Bulletin's* tabulations of social welfare expenditures (excludes Social Security programs).

SOURCES: Gottschalk and Danziger (1984), Tables A-1 and A-2; Gallaway, Vedder, and Foster (1985), Table 3.

In-kind benefits, however, cannot affect measured poverty because the official poverty measure (used in all the studies) is based only on cash income. Since in-kind benefits have grown much more rapidly than cash benefits, the transfer variable used by Gallaway, Vedder, and Foster increasingly becomes irrelevant as a factor that can possibly affect poverty under the official definition, which excludes in-kind benefits from income.

In sum, an examination of long-term trends shows that economic growth lifts incomes at all parts of the income distribution and thereby reduces poverty. Efforts to alter the distribution of income through the tax and transfer system are likely to accomplish less than expected because of offsetting changes in behavior induced by the promise of benefits. Identifying the magnitude of these behavioral effects, however, is a difficult problem.

For this reason analyses of the effects of aggregate social welfare transfers on poverty have not found consistent results. However, it is likely that transfers have on balance contributed to some reduction in poverty. If our poverty statistics were based on an income definition that included non-cash benefits, the reduction would be more apparent.

To say that social welfare transfers reduce poverty is not necessarily an endorsement. Including Social Security, these programs amount to 19 percent of GNP. Any evaluation must take into account not only the dollar costs but also the costs associated with work disincentives and other disincentives.

AFDC and the Female-Headed Family

The program most closely identified with welfare—Aid to Families with Dependent Children—is largely targeted on families with children and no father present. AFDC has come under suspicion as a transfer program generating potentially important disincentives. More than one kind of disincentive may operate—one, the usual work disincentive; another, a disincentive to marry or remarry. This section examines the interrelations between the increase in female-headed families, their work and poverty status, and the AFDC program.

Changing Family Structure

The structure of the family has undergone considerable change over the past 25 years. In 1960, among white families with children of their own under 18, only 6 percent were headed by the mother alone; in 1984 such families represented 15 percent of all white families with children (Table 4). Among black families with children

TABLE 4

CHANGES IN FAMILY COMPOSITION, BY RACE, 1960–84

Percent of Households with Own Children Headed by Mother Only	1960	1970	1980	1984
All races	7.4	10.2	17.6	19.0
White	6.0	7.8	13.4	14.7
Black	20.7	30.6	46.9	48.8

SOURCE: U.S. Bureau of the Census, *United States Census of the Population: 1960,* vol. 1; and *Current Population Reports,* Series P-20, various issues.

the trend was even more pronounced, as families headed only by mothers rose from 21 percent in 1960 to 49 percent in 1984. Underlying these trends is a sharp increase in divorce, a rise in out-of-wedlock births, and an increasing tendency for women with children to set up their own households rather than live with relatives.

Although the causes of marital dissolution (and illegitimacy) are undoubtedly complex and numerous, economic incentives are believed to be important elements in the process. Theoretically, the gains from marriage are expected to be larger, the greater the gains from the division of labor in the household (Becker, Landes, and Michael 1977). For example, the traditional marriage, in which the wife specializes in home activities and the husband in market activities, is likely to be associated with significant marital gains. Moreover, the higher the husband's market earnings and the greater the wife's home skills, the more efficient the arrangement.

Alternatives to marriage, however, come in two forms for women. One is the woman's own prospects for earning an income; the other is welfare. Either route provides a means of financial independence apart from marriage; and the higher the earnings or the higher the welfare benefit, the greater is the independence. There is some research evidence showing that an increase in women's earnings and employment increases marital dissolution (Becker, Michael, Landes 1977). Through feedback, however, divorce and the expectation of divorce also seem to increase women's labor force participation (O'Neill 1981). A discussion of the effect of welfare and other transfer payments on marital dissolution and family formation follows.

The AFDC Program

Federal government participation in welfare activities began with the Great Depression of the 1930s. The intent of Congress was not to establish a federal commitment to support local welfare programs, but rather to establish a national system of social insurance. It soon became evident, however, that it would take several decades for most people to build up enough employment credits for adequate retirement and survivor benefits. Hence, provision was made for a system of federal matching support to help the states fund programs of local public assistance. Only people who fell into certain categories of need—old age, disability, blindness, and the death, disability, or absence of the family's breadwinner—were to be aided by federal funds.

The need for each of these cash assistance categories was expected to lessen as time passed and more of the population was covered by the Social Security system. This has in fact occurred in the case of the old-age assistance program. In the case of aid for dependent children, which later became AFDC, this expectation has not been fulfilled. Indeed this federal-state public assistance program has grown since the end of World War II and is now a major cause of the current public concern over welfare.

The fundamental purpose of the AFDC program has always been to provide for children who are caught unexpectedly in deprived circumstances because of the loss of support by the father (who until the past decade or two was likely to be the family's main breadwinner). The underlying reasons for nonsupport by the father, however, have changed radically since the program began in the 1930s. At that time fully 75 percent of the children covered by the program had fathers who were either dead or severely incapacitated. This percentage has declined steadily. In 1982, 88 percent of fathers of AFDC children were living but absent, and 47 percent had never been married to the children's mother (Committee on Ways and Means, 1985a).

The AFDC program is still administered by the states, and funding is shared with the federal government. States set their own benefit levels and establish income and resource criteria for eligibility, subject to federal limitations. Benefits vary widely among the states. Although the program is largely made up of families without able-bodied fathers at home, several states (25 in 1985) provide benefits, under certain circumstances, to families in which the father is present but unemployed.

Analyses of the patterns of participation show that the majority of women who go on the welfare caseload do not stay long. For example, O'Neill et al. (1984) found that about half of the women starting on welfare do not stay beyond a year. On the other hand, a significant proportion become long-term recipients. About 31 percent of black women and 13 percent of white women remain on AFDC continuously for more than five years.

These data refer to a single welfare spell and, therefore, understate lifetime participation since many women undoubtedly return to the program. Data limitations make it difficult to develop reliable measures of total lifetime welfare participation. Ellwood (1986), however, has estimated that, counting all spells, about 70 percent of women embarking on a first spell will accumulate more than two years on welfare, 50 percent 5 years or more, and 24 percent will accumulate as many as 10 or more years. Thus, for many participants, AFDC is an episode providing temporary aid during a period of financial distress. For a significant proportion, however, AFDC seems to become a permanent substitute for other sources of income, with dependency lasting 10 years or more.

Do High AFDC Benefits Affect Marital Status?

A key issue is whether government policy, through the generosity of welfare benefits, has itself influenced women to divorce or separate, to have a child out-of-wedlock, or in other ways change marital and family patterns. One way to address the question is by examining changes in benefit levels, caseload growth, and family structure over time.

The pattern of growth in the AFDC caseload over time appears to correspond to the change in the benefit level over time (Table 5). Between 1964 and 1972 the average real benefit (for a family of four with no other income) increased by 35 percent. This does not reflect the introduction of earnings exemptions, or of medicaid, public housing, school meals, and other programs and services, which significantly added to the value of the welfare package during this period. Even without these add-ons, the cash benefits plus food stamps provided an average allotment of close to $9000 in 1972 (for the family of four without other income, expressed in 1984 dollars). This income was tax free and required no hours of work away from home or work expenses. It may well hve appeared an attractive alternative for a woman with little education, few work skills, and poor marriage prospects. Moreover, as shown in Table 5, the AFDC benefit level not only rose absolutely but also rose relative to the earnings of potential husbands (represented by male earnings) or of women working full-time.

During this period of rapid benefit increases, the number of female-headed families on AFDC tripled. This was the outcome of a doubling in the percentage of female-headed families going on welfare

TABLE 5

TRENDS IN AFDC FAMILIES AND BENEFITS AND IN FEMALE-HEADED FAMILIES WITH CHILDREN

Year	Number of AFDC Families[a]	Number of Female-Headed Families with Children (FHFC)	Annual AFDC Families as Percent of FHFC	Real AFDC and Food Stamp Benefits[b]	Benefits[c] as % of Male Annual Earnings	Benefits[c] as % of Female Annual Earnings (Full-Time Year Round)
1964	992	2895	34.3	6604	42.4	53.2
1968	1400	3269	42.8	7129	39.9	52.3
1972	2915	4322	76.4	8894	48.1	59.2
1976	3444	5310	64.8	8743	50.8	57.6
1980	3570	6299	56.6	7486	47.4	51.2
1984	3438	6832	50.3	6955	44.6	45.1

[a] Excludes families with unemployed father. Average monthly number of recipients in calendar year except for 1984, which is for fiscal year.

[b] Col. 4 represents benefits for a family of four with no other income, expressed in 1984 dollars.

[c] Real AFDC and food stamp benefits as found in col. 4.

SOURCES: AFDC families: *Social Security Bulletin*, various issues; female-headed families with children: Committee on Ways and Means (1985b, Table 3-2); U.S. Bureau of the Census, *Current Population Reports*, Series P-20, various issues; AFDC and food stamp benefit levels: Committee on Ways and Means (1985a, p. 532); annual earnings (median): Council of Economic Advisers (1986, Table B-29).

(from 34 percent to 67 percent) as well as a 50 percent rise in the number of female-headed families.

After 1976 the total AFDC benefit package began to erode as states failed to raise AFDC cash benefit levels to keep pace with inflation.[7] Since this was a period of stagnant or declining incomes for Americans in general, the relative decline in benefits (relative to earnings) is less than the absolute decline would suggest. At the point when benefits stopped rising, the AFDC caseload stopped rising. Following the changes introduced in the Omnibus Budget Reconciliation Act of 1981, which restricted benefits somewhat, there was a small decline in the caseload, despite rising unemployment.

The data strongly suggest that rising welfare benefit levels are associated with an increase in welfare participation. Up to 1976 the data are also consistent with the hypothesis that increasing welfare benefits induce changes in family structure. After 1976, however, the number of female-headed families continued to increase even though the number of welfare families remained fairly constant. This finding alone does not negate the hypothesis. It would be naive to suppose that welfare benefits were the only factor affecting family structure. Women's opportunities for employment are also important and throughout the period these opportunities expanded (O'Neill 1981, 1985a). It should also be noted that the rate of increase in female-headed families slowed during the late 1970s and early 1980s, which may reflect the decline in relative benefit levels.

Several studies have examined AFDC disincentive effects, controlling for the effects of other factors. A clear association between the generosity of AFDC benefits and program participation has been found by a number of analysts.[8] A positive correlation between benefit levels and the relative number of female-headed families has also been found in studies using aggregate data, across metropolitan areas (Honig 1974; Ross and Sawhill 1975). Studies based on microdata have sometimes found no effect of transfers on marital dissolution (Sawhill et al. 1975; Hoffman and Holmes 1976). Wolf (1977) suggests that these weaker findings may result from inadequate control for the economic alternatives to welfare, such as the potential wage of the woman and her employment opportunities.[9]

---

[7] Using the official CPI, the decline in the real AFDC benefit from 1976 to 1984 is 20 percent. Using Weicher's (1986) recalculated CPI, which adjusts for the error in housing price increases before 1983, the real decline is 16 percent.

[8] Honig (1974) has analyzed the static incidence of welfare receipt. Plotnick (1983), Wiseman (1977), Hutchens (1981), Saks (1975), and O'Neill et al. (1984) analyzed welfare exit probabilities (or welfare duration). These authors have found that the probability of exit is likely to fall when welfare benefits are higher relative to potential earnings.

The same level of welfare benefits in a state will not be equally attractive to all women, even those with the same education. For example, a woman with a substantial work record will likely have higher potential earnings than a woman with little work experience. Welfare would likely be relatively less attractive to the former than to the latter. When Wolf improves the specification of his model to take better account of earnings alternatives to welfare, he finds a positive association between AFDC benefits and marital dissolution.

In general, however, no definitive study of the effect of welfare benefits on family structure has been done, because the data needed to measure work opportunities, marriage opportunities, and the real level of the welfare package have proven difficult to obtain. The studies using aggregate data are better able to measure variation in AFDC relative to earnings or other alternatives, which may explain why these studies have shown stronger links between welfare and family structure.

I am inclined to believe that welfare has had a significant effect on family structure, particularly among the population with little education and weak economic opportunities. The relative attractiveness of welfare would clearly be greater for these groups. Among those with more education and better earnings prospects, the increase in women's earnings opportunities is likely to be the more important factor enabling women to set up their own households.

The sharper rise and higher level of marital dissolution and out-of-wedlock births among blacks may be attributed to the disproportionate effects of both welfare and women's earnings on blacks compared with whites. A larger proportion of black women than white women fail to graduate from high school.[10] On the other hand, the earnings of black working women have increased dramatically over the past two decades, rising relative to virtually all other groups. In the early 1960s, black women earned about 60 percent as much as black men; by 1982 this earning ratio was close to 80 percent (O'Neill 1985a). The rapid rise in the relative earnings of black women may have been destabilizing to marriages during the transition period.

---

[9] The same criticism is applicable to recent research by Ellwood and Bane (1984), who conclude that welfare has little effect on family structure. But their analysis suffers from errors of measurement, since they did not control for the relative attractiveness of welfare to different individuals within a state.

[10] The 1980 Census shows that among black women aged 25 to 34, 18 percent had not gone beyond the 10th grade; 25 percent had not completed high school. Among white women these percentages were 10 percent and 13 percent, respectively.

Some authors, notably Wilson and Neckerman (1986), have assigned the blame for the increased disintegration of the black family on growing black male joblessness. However, the rise in female-headed families began in the 1960s when unemployment for black men, as for others, was falling. For example, the out-of-wedlock birth rate for black women ages 15 to 19 rose sharply between 1965 and 1970, although the unemployment rate of black men was substantially lower than it had been during the early 1960s.[11] Black male unemployment climbed during the late 1970s and early 1980s. But out-of-wedlock birth rates leveled off and then declined during this period, and, as noted, the rate of formation of female-headed families also slowed. Moreover, during the period 1960–80, annual income of black males was rising relative to that of white males, despite any increases in unemployment.[12] In the 1940–60 period the black family was essentially a two-parent family, although both in absolute and relative terms black male income was much lower in that period. One must look at factors other than the economic situation of black men to find the motivation for disintegration of the black family. The two most likely reasons are the expansion of the welfare state, which played a role from 1965 to 1975, and the rise in the earnings of black women relative to black men.

Work Incentives

High levels of welfare benefits are believed to discourage work as well as marriage and thereby increase dependency. The availability of an acceptable income guarantee induces women who would otherwise work to go on welfare. Of course, welfare could be used to supplement work, but it seldom is. The percentage of welfare mothers who are employed at any time has always been low.

Several studies have documented a negative effect of welfare benefits on work effort. Findings from the Seattle-Denver Income Maintenance Experiment (U.S. Office of Income Security Policy 1983) show that female heads of families responded to income guarantees by significantly reducing their work effort. Other studies have found that women are less likely to work in states with high levels of AFDC benefits (O'Neill 1985b). Because withdrawal from the labor force reduces work experience and training, it also reduces potential earnings and thereby increases future dependency.

---

[11] The black male unemployment rate for the period 1960–65 averaged 10.2 percent; for 1965–70 the rate averaged 6.3 percent. These data are for black and other nonwhite males (Council of Economic Advisers 1982, Table B-33).

[12] Based on data from the decennial censuses the black/white ratio of annual income of men aged 25 to 34 increased from 57 percent in 1960 to 74 percent in 1980. These data include the earnings of all men with any earnings during the year and therefore reflect changes in weeks of unemployment as well as in hourly wage rates and hours worked per week.

Efforts to increase work effort among welfare recipients have not had much success. In 1967 the Work Incentive Program (WIN) attempted to make work more attractive by allowing welfare recipients to keep a larger proportion of their benefit if they worked. Prior to that time, a dollar of benefits was lost for each dollar earned. Under WIN, the first $30 of monthly income was exempted, after which benefits were reduced by 67 cents for each additional dollar earned. Despite this change, however, the proportion of welfare women employed remained at 15–16 percent. In fact, the change may have decreased work effort for female-headed families as a whole, since the liberalization of the program seems to have attracted more women to welfare, but once on the program these women worked less than they otherwise would have.[13] In 1981, as part of an effort to tighten program eligibility, the 1967 "incentive" provisions were eliminated after four months of consecutive employment. A study by the Research Triangle Institute (1983) found that the change had no effect on work patterns of women on AFDC in 1981. It will take more years of observation, however, before a full evaluation can be made.

Family Structure and Poverty Rates

The changes in family structure have affected statistics on income and poverty. Female-headed families, particularly those with children, are more likely to have low incomes than husband-wife families. Fathers do not provide child support in many cases or such support is minimal. For example, in 1981 only 35 percent of women who have children from an absent father received any child support payments. The prospective earnings of single mothers are typically lower than those of men because most women have less work experience and occupational training. Moreover, responsibilities for small children place limitations on the hours and kinds of jobs that can be held. Families headed by single mothers will have lower income simply because there is no spouse to be a second earner.

An additional factor is that female family heads with little or no earnings are likely to be on welfare, and cash welfare benefits do not bring a family above the poverty line. Families on welfare, however, are apt to receive noncash benefits that would in some cases raise their income over the poverty line if these benefits were counted as income. Thus, the poverty rate for female-headed families falls from 34.5 percent to 21.3 percent when the poverty definition is adjusted to include food, housing, and medical benefits as income.

---

[13] See the study by Levy (1979), which found that lower marginal tax rates on AFDC seem to reduce total work effort for the reasons stated above.

For these reasons, the poverty rate of female-headed families is higher than that of other (primarily husband-wife) families. In 1984 the poverty rate of female-headed families was 34.5 percent compared with 6.9 percent for married-couple families (Table 6). Among female-headed families poverty status varies with the woman's work status. The poverty rate of a female-headed family was only 6.7 percent if the woman worked full-time year round, but it was 56.4 percent if she never worked during the year. The incomes of this group are not strictly comparable, as they are likely to include substantial in-kind transfers that are not counted in the official poverty measures.

Over the years, the number of people in female-headed families has increased as a percentage of the poor, both because they have increased as a percentage of the population and because their poverty rate did not decline as fast as that of the rest of the population. This is what is meant by the expression "the feminization of poverty."

These changes have implications for the overall poverty rate. Mary Jo Bane (1986) has calculated that if household structure had remained as it was in 1959 and the poverty rate for each household type changed as it actually did, the overall poverty rate in 1979 would have been 7.8 percent instead of 9.1 percent for whites and 24.2 percent instead of 30.9 percent for blacks. As Bane notes, this calculation is likely to

TABLE 6

POVERTY RATES OF FAMILIES BY WORK EXPERIENCE AND SEX OF FAMILY HEAD, 1959–84

	1959	1979	1984
Families with Female Head[a]	42.6	30.2	34.5
Head worked ever during the year	33.3	18.9	21.0
Worked full-time, year round	16.6	5.4	6.7
Head never worked during the year	54.1	49.5	56.4
Families with Male Head	15.8	5.5	7.2
Head worked ever during the year	13.4	3.8	5.4
Worked full-time, year round	9.1	2.2	3.1
Head never worked during the year	39.4	13.9	14.5

[a] No husband present.

SOURCE: U.S. Bureau of the Census, *Current Population Reports,* Series P—60 (various issues).

overestimate the effect.[14] Even if the true effect were only half, however, compositional changes in family structure have a significant impact on measured poverty.

Does Welfare Cause Poverty?

The answer is complex. One would not expect a woman to choose poverty voluntarily. In a mechanical sense a woman may forgo a higher cash income based on full-time earnings for a lower cash income from welfare. In a real sense, however, her income may be higher on welfare because of noncash benefits, the absence of work or work expenses, more leisure, and more time with her children. Welfare may increase poverty indirectly if it leads to choices that close off options for self-improvement. For example, if welfare encourages out-of-wedlock births among teenage girls, the long-run effects may be lower education and training, which would in turn reduce future earnings and affect other aspects of life.

Regional differences in the share of families headed by women and in their poverty rates may be traced to differences in welfare levels. In the southern states, the maximum AFDC benefit for a family of four ranges from $120 to $379 a month, while elsewhere the benefit ranges from $282 to $676 a month. Despite lower levels of education in the South, a characteristic associated with out-of-wedlock births and marital dissolution, the percentage of black families headed by women was 40 percent in the South compared with 48 percent outside the South (Table 7). Among black children, 46 percent were in female-headed families in the South; 59 percent outside the South. Among white families, 12 percent in the South and 13 percent in the non-South were female headed. These data support the view that high welfare benefit levels contribute to marital dissolution and the formation of female-headed families.

It is also noteworthy that the low benefit strategy of the South has not produced more poverty. The measured poverty rate in 1984 among female-headed families was somewhat lower for both blacks and whites in the South than it was in the North and West. Evidently, women in the South, who are less likely to be on welfare, develop more work experience and have higher earnings, which more than compensates for the lower welfare benefits.

---

[14] The calculation is likely to overestimate the effect, since it assumes that women who become family heads are randomly drawn from other families. If they were disproportionately drawn from poor families, some of the additional poverty in female-headed families would simply be "reshuffled poverty." The extent of reshuffled poverty is hard to estimate, however.

TABLE 7

POVERTY RATES IN FEMALE-HEADED FAMILIES AND FEMALE HEADSHIP IN THE SOUTH AND NON-SOUTH, 1984

	Poverty Rate		Percent of Population in Female-Headed Families	
	South	Non-South	South	Non-South
Blacks				
Family Heads	50.7	52.6	39.8	48.1
Children under 18	64.3	68.0	46.4	59.0
Whites				
Family Heads	22.9	28.9	11.9	13.2
Children under 18	38.9	48.7	13.4	15.2

SOURCE: U.S. Bureau of the Census, Current Population Survey, unpublished tables.

Perhaps the most important question about the effects of AFDC concerns the effects of long-term welfare dependency on the children in AFDC families. Are they more likely to become unemployed, commit crimes, be less well motivated in school, become teenage mothers, and ultimately to go on welfare? Because of a lack of data, there has been no solid research in these areas, although abundant anecdotal evidence suggests that these outcomes may be real.

Conclusion

The extent of poverty in the United States has largely been determined by the state of the economy. Efforts to redistribute income have succeeded in shifting income from the young to the old, and at enormous cost have helped to reduce poverty among the aged. Transfers from the rich to the poor among the nonelderly population have been done on a more modest scale, but with little observable positive effects on measured incomes.

It is difficult if not impossible, however, to design a system intended to provide assistance to needy families headed by an able-bodied adult and at the same time avoid harmful disincentives. "Need" is not an inherent trait but is to a large extent the consequence of voluntary decisions relating to work, fertility, and marriage. Therefore, the extent of need is not a fixed number but is susceptible to change based on incentives offered. Efforts to change behavior through work requirements and work and training programs have not had significant effects, as the history of the WIN program testifies. If welfare benefits remain high, work programs will always have trouble competing. On the other hand, individuals can become the victims of past choices, and, particularly where children are concerned, it is difficult to ignore their plight. These conflicts have created the basic dilemma of welfare.

Hard choices must, therefore, be made. Implicitly the public has chosen to cut back on welfare. The funding provided to welfare programs has leveled off in the past decade. Cash benefit levels in AFDC have declined in real terms. As a result, the welfare caseload has also stopped rising. There also are signs that the formation of female-headed families is not rising as rapidly as it was and that the out-of-wedlock birth rate is steady or falling slightly.

In seeking new options for welfare one possible direction is to remove the open-ended aspect of AFDC for families headed by able-bodied adults and to place a finite limit on program duration, as is the case with unemployment insurance. In this way welfare would no longer be able to replace other sources of income on a permanent basis. Another direction already underway is the requirement that absent fathers contribute to their children's support. Although the income provided might not remove many from the AFDC caseload, it would perhaps foster greater concern for the consequences of behavior and, hence, prevent the birth of children who cannot be supported by their parents. Finally, it should be emphasized that prevention measures, such as improving basic education, may have the added pay off of reducing welfare dependency in the long run.

References

Bane, Mary Jo. "Household Composition and Poverty: Which Comes First?" In *Fighting Poverty: What Works and What Doesn't*, pp. 209–31. Edited by Sheldon H. Danziger and Daniel H. Weinberg. Cambridge, Mass.: Harvard University Press, 1986.

Becker, Gary S.; Landes, Elisabeth M.; and Michael, Robert T. "An Economic Analysis of Marital Instability." *Journal of Political Economy* 85, no. 6 (1977): 1141–85.

Council of Economic Advisers. *Economic Report of the President*. Washington, D.C.: Government Printing Office, 1982 and 1986 editions.

Ellwood, David T. *Targeting "Would-Be" Long-Term Recipients of AFDC*. Contract no. 100-84-0059. U.S. Department of Health and Human Services, OS/ASPE, January 1986.

Ellwood, David T., and Bane, Mary Jo. *The Impact of AFDC on Family Structure and Living Arrangements*. Report to U.S. Department of Health and Human Services. Grant no. 92-A-82, John F. Kennedy School of Government, Harvard University, 1984. Mimeo.

Gallaway, Lowell; Vedder, Richard; and Foster, Therese. "The 'New' Structural Poverty: A Quantitative Analysis." *Hearing Before the Subcommittee* *on Monetary and Fiscal Policy*. Joint Economic Committee of the Congress, 20 June 1985.

Gottschalk, Peter, and Danziger, Sheldon. "Macroeconomic Conditions, Income Transfers, and the Trend in Poverty." In *The Social Contract Revisited*, pp. 185–215. Edited by D. Lee Bawden. Washington, D.C.: Urban Institute Press, 1984.

Harrington, Michael. *The New American Poverty*. New York: Harper and Row, 1984.

Hoffman, Saul, and Holmes, John "Husbands, Wives, and Divorce." In *Five Thousand American Families*, vol. 4. Edited by J. N. Morgan. Ann Arbor: Institute for Social Research, University of Michigan Press, 1976.

Honig, Marjorie. "AFDC Income, Recipient Rates and Family Dissolution." *Journal of Human Resources* 9 (1974): 303–23.

Hutchens, Robert M. "Entry and Exit Transitions in a Government Transfer Program: The Case of Aid to Families with Dependent Children." *Journal of Human Resources* 16 (1981): 217–37.

Leonard, Jonathan S. "The Social Security Disability Program and Labor Force Participation." Working Paper no. 392, National Bureau of Economic Research, 1979.

Levy, Frank. "The Labor Supply of Female Household Heads, or AFDC Work Incentives Don't Work Too Well." *Journal of Human Resources* 14 (1979): 76–97.

Murray, Charles. *Losing Ground*. New York: Basic Books, 1984.

O'Neill, June. "A Time Series Analysis of Women's Labor Force Participation." *American Economic Review* 71 (May 1981): 76–80.

O'Neill, June. "Comment" on Gottschalk and Danziger. In *The Social Contract Revisited*, pp. 216–19. Edited by D. Lee Bawden. Washington, D.C.: Urban Institute Press, 1984.

O'Neill, June. "The Trend in the Male-Female Wage Gap in the U.S." *Journal of Labor Economics* 3, no. 1, pt. 2 (1985a): S91–S116.

O'Neill, June. *Determinants of Child Support*. Grant no. 1 RO1 HD 16940-01. National Institute of Child Health and Human Development, Institution of Health, 1985b.

O'Neill, June A.; Wolf, Douglas A.; Bassi, Laurie J.; and Hannan, Michael T. "An Analysis of Time on Welfare." Report to ASPE/Department of Health and Human Services. Washington, D.C.: Urban Institute, 1984.

Parsons, Donald O. "The Decline of Male Labor Force Participation." *Journal of Political Economy* 88 (1980): 117–34.

Plotnick, Robert. "Turnover in the AFDC Population: An Event History Analysis." *Journal of Human Resources* 18 (1983): 65–81.

Research Triangle Institute. *Final Report: Evaluation of the 1981 AFDC Amendments*. Submitted to Office of Family Assistance, Social Security Administration, Department of Health and Human Services, 1983.

Ross, Heather L., and Sawhill, Isabel. *Time of Transition: The Growth of Families Headed by Women*. Washington, D.C.: Urban Institute, 1975.

Saks, Daniel. *Public Assistance for Mothers in an Urban Labor Market*. Princeton: Princeton University, Industrial Relations Section, 1975.

Sawhill, Isabel et al. *Income Transfers and Family Structure*. Washington, D.C.: Urban Institute, 1975.

U.S. Congress. House. Committee on Ways and Means. *Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*. 99th Cong., 1st sess., 22 February 1985a.

U.S. Congress. House. Committee on Ways and Means. *Children in Poverty*. 99th Cong., 1st sess., 22 May 1985b.

U.S. Department of Commerce. Bureau of the Census. *Estimates of Poverty Including the Value of Noncash Benefits: 1984*. Technical Paper 55. Washington, D.C.: Government Printing Office, August 1985.

U.S. Department of Health and Human Services. Office of Income Security Policy. *Overview of the Seattle-Denver Income Maintenance Experiment Final Report*. Washington, D.C.: Government Printing Office, May 1983.

Weicher, John. "Mismeasuring Poverty and Progress." American Enterprise Institute, 1986. Mimeo.

Wilson, William J., and Neckerman, Katherine M. "Poverty and Family Structure: The Widening Gap Between Evidence and Public Policy Issues." In *Fighting Poverty: What Works and What Doesn't*, pp. 232–59. Edited by Sheldon H. Danziger and Daniel H.. Weinberg. Cambridge, Mass.: Harvard University Press, 1986.

Wiseman, Michael. *Change and Turnover in a Welfare Population*. Report on the Income Dynamics of the Poor Project. Berkeley, Calif.: Institute of Business and Economics Research, University of California, 1977. Mimeo.

Wolf, Douglas A. "Work-Conditioned Transfers and Marital Dissolution: An Empirical Study of the Economics of Marriage." Paper presented at the annual meeting of the Econometric Society, New York City, December 1977.

THE SPATIAL PERSPECTIVE IN WELFARE ANALYSIS

Janet E. Kodras

Controversies in the Welfare Literature

In her review of public assistance transfers, June O'Neill (1986) addresses several of the most trenchant debates that currently separate proponents and critics of the U.S. welfare system:

- Is the recent rise in poverty due to a deteriorating economy or an expanding transfer system?
- Are opportunities in the labor market or the welfare system primarily responsible for increases in female headed households and the often attendant poverty of this group?
- Does welfare exhibit identifiable impacts on work incentives and attitudes toward family?

Drawing on several of her recent empirical analyses and the research of others, O'Neill takes a position in each of these controversies, concluding that economic changes, rather than welfare alterations, are the more evident generators of recent poverty; that the increase in female households reflects a number of societal mechanisms, including labor market opportunities, welfare options, and the breakdown of traditional family norms; and that the expansion of AFDC has impacted on family composition and the labor force participation of females but has not worsened poverty, at least in the short term.

Although the research on which her conclusions are based seems sound, it is difficult to accept O'Neill's statements as the final truth on such matters, since there exist, throughout the welfare literature, equally justifiable analyses that draw the opposite conclusions. O'Neill confronts these contradictions in the literature, attributing them to several factors: In some cases, similar models have yielded different results because the statistical techniques are sensitive to the way

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Assistant Professor of Geography at Florida State University.

they were specified. In particular, she refers to time series analysis as "slippery business." In other cases, researchers have reached different conclusions because they have used variable definitions of fundamental concepts such as "poverty" or "welfare benefits." Finally, advocates of different positions have chosen to include or exclude certain factors, such as in-kind benefits, in their analyses. Each of these points made by O'Neill is important and the arguments ricocheting throughout the welfare literature often focus on methodology and model specification, which influence conclusions drawn from analyses.

I suggest that an additional reason why the body of research on welfare has so often yielded conflicting results is our general failure to consider the effect of temporal and spatial specification on our results. Stated simply, the times and places considered in a welfare analysis affect the conclusions. This point is perhaps most evident when we consider the temporal dimension, since some research has already been initiated. The current work on welfare dynamics, as reported by O'Neill, allows us to readdress issues such as the duration of welfare dependency and intergenerational transfers of attitudes toward work and welfare. This new research illustrates the importance of carefully considering how time is specified in the analysis.

Given this developing focus, we are now in a position to examine various arguments in the welfare literature. For example, a number of studies have disagreed over the extent of the relationship between poverty and welfare participation. It may be that a given poverty rate may translate into *lower* welfare use in those political eras in which the stigmas attached to public assistance are emphasized and *greater* participation in times when assistance is portrayed as an entitlement to those displaced in a dynamic economy. From a modeling standpoint, we are asking whether the *parameter*, which estimates the relation between poverty and participation, varies over time due to changing stigmas. From a conceptual standpoint, we are asking whether the *validity* of each position in the debate changes over time. Viewed in this context, studies conducted on different historic eras would be expected to yield different results, a recognition which may help to resolve conflicts in the literature.

A Spatial Perspective

The need to incorporate a spatial perspective in welfare analysis is perhaps less evident. Many of the existing studies do employ data drawn from areal units, yet very rarely do they consider that the conceptual arguments may themselves have a spatial dimension. Stated another way, we need to consider the possibility that the different positions in a welfare debate may hold true to varying extents in different parts of the nation (Jones 1984; Jones and Kodras 1986).

There may be a reason why advocates of the various positions draw examples from different places to support their cases. When President Reagan wishes to stress a point on welfare fraud, he often uses anecdotes from large Northeastern cities, where welfare bureaucracies are often so overloaded that some of the undeserving no doubt receive benefits. An example is the account of Chicago's Welfare Queen, a woman accused of misrepresenting herself as the widow of several deceased Navy men and collecting welfare and widow's grants, which Reagan often included in presidential campaign speeches (Hannaford 1983, pp. 90–91). When Piven and Cloward (1971) portrayed welfare as a tool manipulated in the interests of capital, they drew most of their examples from the rural South, where, during the 1950s and 1960s, welfare was quite stringently controlled to prevent it from drawing workers away from Southern agriculture. With regard to our most recent and famous welfare anecdote (Murray 1984), in which Phyllis and Harold decide between work and marriage versus welfare and separation, Murray and Greenstein (1985; and Greenstein 1985) have discussed whether Phyllis and Harold's decision was affected by the fact that they lived in the liberal welfare state of Pennsylvania rather than a more conservative state such as Mississippi. It is evident in all of these examples that the advocates of different positions use regions that support their cases most strongly. The implicit assumption is that the anecdote serves as a general example, applicable throughout the country. Most often, this assumption is not justifiable.

Why *should* the arguments concerning welfare vary in their validity throughout the country? By adding a spatial dimension to the issues studied by O'Neill and others, how can welfare alleviate poverty in some areas but exacerbate problems in others? How can welfare act as a work disincentive in some places more than others? How can welfare influence family composition in a very different way here than it does over there? The U.S. public assistance system plays variable roles and exerts different impacts throughout the country because, first, in a federal system of government the individual states administer the programs very differently, and second, welfare, as a secondary economic institution, is inserted into very different economic and cultural contexts.

Spatial Dimensions of Welfare

First consider the federalized nature of public assistance. To the extent that research has considered the spatial dimension of welfare, analyses are most often confined to interstate variations in AFDC benefits. These disparities are substantial. In 1984, a family of four with no other income could receive monthly AFDC checks of $800 in Alaska and $660 in California but only $120 in Mississippi and $147 in Alabama (USDHHS 1985, p. 337).

The geographic complexity of welfare involves much more than variations in benefits, however. Each state determines AFDC eligibility by comparing family circumstances to its own need standard. Whereas Georgia and Michigan determine basic needs by considering only the costs of food, shelter, clothing, utilities, and personal care items, Connecticut considers 20 cost items, including educational expenses, dry-cleaning bills, insurance premiums, and summer camp fees (USDHHS 1984, p. 73). Thus, a family with a given set of circumstances is eligible in some states, not in others. Further complexity is added since the states vary in the proportion of the need standard that they will pay to recipients. Only 18 states pay up to the level of the need standard they determined was necessary in the first place (USDHHS 1985, p. 335). In addition, the states have the discretion to include or exclude several optional components of the overall AFDC program. About half the states provide the unemployed parent option, half do not. A final example is that the states vary in the funding and political support of their welfare systems, which influence, among other things, the efficiency of operation, size of payments, and restrictiveness of administration.

In summary, decentralized control of AFDC has resulted in substantial interstate variations in benefits (Wohlenberg 1976b), eligibility determination (Chief 1979), restrictiveness (Wohlenberg 1976a), and the response to need for assistance (Jones 1984; Jones and Kodras 1986; Wohlenberg 1976c). When these geographic variations in AFDC are combined with disparities in the provision of other programs, such as general assistance, medicaid, and food stamps, it is evident that where one lives affects the types and amounts of public assistance available.

Welfare in Spatial Context

Welfare also exerts variable effects throughout the country because it is inserted into different economic and cultural contexts. For example, the nature of poverty varies spatially. In the deep South, the incidence of poverty is higher in rural areas and often consists of intact families who remain poor over the long term due to stagnant economic conditions, historically persistent. In the industrial Northeast, on the other hand, the poor tend to be concentrated in large, urban areas, are more apt to be divided families, particularly female-headed households, and there seems to be greater movement in and out of poverty in accordance with unemployment cycles (U.S. Bureau of the Census 1983, Table 203). The programs comprising the U.S. welfare system respond in different ways within these two settings. The decentralized AFDC program is more relevant in the industrial Northeast. Since it serves primarily single-parent households, AFDC is not available to the large number of intact poverty families in the South; those single-parent households that are eligible would receive relatively small benefits. In addition, the agglomeration of the poor in spatially segregated neighborhoods of the Northeastern cities ensures greater access to welfare offices than is the case for the rural poor in the South, who must often travel to the county seat to apply and participate. Given these circumstances, it is small wonder that AFDC participation rates are higher in the Northeast than in the deep South. The food stamp program, on the other hand, is more strongly controlled at the national level and has circumvented restrictive state welfare programs in the South (Kodras 1982). Benefits are available to all households, regardless of composition or location, who meet nationally uniform eligibility criteria. Thus, intact poverty families in the South are eligible and receive the same benefits as elsewhere. Although the rural poor still have problems with access to welfare offices, food stamp participation rates for the South as a whole tend to be high relative to other regions (Kodras 1984).

The major alternative to welfare receipt is employment, but opportunities in the labor market are spatially variable as well. Each local area provides different earnings potentials due to its position in the core or periphery of the national economy, its intersectoral mix of employment concentration, and the attendant wage structures (Kodras 1986). Those areas with high skill requirements may provide relatively few opportunities for technologically displaced labor, the uneducated or unskilled, and many new or return entrants to the labor market. Other areas, with long agrarian histories and recent industrialization, unionization resistance, or traditions of discrimination, as well as areas leading the restructuring toward a low-wage service economy, may provide many job opportunities, as an alternative to welfare, but at such low compensation that even full-time employment is not sufficient to raise a family above the poverty level. In Mississippi, for example, of all female-headed families where the head works full-time, full-year, over 20 percent remain poor (U.S. Bureau of the Census 1983, Table 246). The poverty rate of fully employed black female families in the state is over one-third. In

Michigan, by contrast, only 3 percent of fully employed female heads live in poverty.

Finally, welfare is inserted into different cultural contexts. There exist spatial variations in the attitudes toward welfare due to regional political cultures (Elazar 1972), spatial differentials in religious cultures (Hutcheson and Taylor 1973; Stonecash and Hayes 1981), and urban-rural variations in the dependence on government institutions versus extended family structures for assistance. Each of these influences the way in which welfare is utilized.

The Geography of Ideology

The evident spatial variations in poverty, the labor market, welfare systems, and attitudes toward public assistance indicate that individuals are confronted with very different combinations of opportunities and constraints, depending on where they live. In a recent study (Kodras 1986), it was demonstrated that the work disincentive effect of welfare varies throughout the country due to different options for employment and for obtaining welfare. The analysis of 1980 AFDC recipiency in the states indicated that welfare use is most responsive to work disincentives in the upper Midwest, lower New England, and along the West coast, where the employment structure is generally not oriented toward the needs of potential AFDC recipients and where welfare is relatively liberal. The work disincentive effect is lowest in the Southeast, where low-skill jobs are more readily available and AFDC is restrictive. Thus, the decision between work and welfare is not voluntary nor is it aspatial, as assumed by economic theory; instead it varies according to the context in which one lives. Advocates for and against the work disincentive argument can find support for their positions, depending on the section of the country they examine.

The point is that ideology has a spatial pattern of applicability. Certainly, the various debates concerning the role and impact of welfare will never be resolved fully, due to the ideological differences we each bring to our work, a priori. We will continue to see the substantial research of O'Neill and the studies of her colleagues stand in disagreement with the findings of others. But if we are to confront our ideological differences, we must first recognize that our arguments have contextual validity; they are temporally and spatially specific.

References

Chief, Elizabeth. "Need Determination in AFDC Programs." *Social Security Bulletin* 42 (September 1979): 11–21.

Elazar, Daniel. *American Federalism: A View from the States.* New York: Harper and Row, 1972.

Greenstein, Robert. "Losing Faith in 'Losing Ground'." *The New Republic* 192 (25 March 1985): 12–17.

Hannaford, Peter. *The Reagans: A Political Portrait.* New York: Coward-McCann, 1983.

Hutcheson, John D., and Taylor, George A. "Religious Variables, Political System Characteristics, and Policy Outputs in the American States." *American Journal of Political Science* 17 (May 1973): 414–21.

Jones, John Paul. "A Spatially Varying Parameter Model of AFDC Participation: Empirical Analysis Using the Expansion Method." *The Professional Geographer* 36 (November 1984): 455–61.

Jones, John Paul, and Kodras, Janet E. "The Policy Context of the Welfare Debate." *Environment and Planning* A 18 (January 1986): 63–72.

Kodras, Janet E. "The Geographic Perspective in Social Policy Evaluation: A Conceptual Approach with Application to the U.S. Food Stamp Program." Ph.D. dissertation, Ohio State University, Columbus, Ohio, 1982.

Kodras, Janet E. "Regional Variation in the Determinants of Food Stamp Program Participation." *Environment and Planning C* 2 (May 1984): 67–78.

Kodras, Janet E. "Labor Market and Policy Constraints on the Work Disincentive Effect of Welfare." *Annals of the Association of American Geographers* 76 (June 1986): 228–46.

Murray, Charles. *Losing Ground: American Social Policy 1950–1980.* New York: Basic Books, 1984.

Murray, Charles, and Greenstein, Robert. "The Great Society: An Exchange." *The New Republic* 192 (8 April 1985): 21–23.

O'Neill, June. "Transfers and Poverty: Cause and/or Effect?" *Cato Journal* 6 (Spring/Summer 1986): 55–76.

Piven, Frances Fox, and Cloward, Richard. *Regulating the Poor: The Functions of Public Welfare.* New York: Vintage, 1971.

Stonecash, Jeff, and Hayes, Susan. "The Sources of Public Policy: Welfare Policy in the American States." *Policy Studies Journal* 9 (Spring 1981): 681–98.

U.S. Department of Commerce. Bureau of the Census. *United States Census of Population: 1980.* Washington, D.C.: Government Printing Office, 1983.

U.S. Department of Health and Human Services. *Characteristics of State Plans for Aid to Families with Dependent Children.* Washington, D.C.: Government Printing Office, 1984 and 1985 editions.

Wohlenberg, Ernest. "An Index of Eligibility Standards for Welfare Benefits." *The Professional Geographer* 28 (November 1976a): 381–84.

Wohlenberg, Ernest. "Interstate Variations in AFDC Programs." *Economic Geography* 52 (July 1976b): 254–66.

Wohlenberg, Ernest. "Public Assistance Effectiveness by States." *Annals of the Association of American Geographers* 66 (September 1976c): 440–50.

THE COST OF REDUCING ECONOMIC INEQUALITY

Edgar K. Browning and William R. Johnson

The publication of Charles Murray's (1984) book *Losing Ground* has rekindled interest in the role of government in promoting economic equality using redistributive tax and expenditure programs. Murray concludes that spending on poverty programs may well have increased the number of poor people and that eliminating many of these programs might be a better antipoverty strategy. These conclusions reflect the view that the adverse incentive effects of social programs, such as the discouragement of work effort and saving by the poor, more than offset the positive contributions the programs make by providing income transfers. Many scholars, however, have criticized Murray, arguing that much evidence suggests the disincentive effects of social programs are not large enough to offset the income-enhancing effects of the policies (see, for example, Danziger and Gottschalk 1985).

We tend to agree that Murray has overstated his case, but we also believe that the debate has obscured an important aspect of the issue, namely, the importance of distinguishing between the overall effects of social programs and the effects of small changes in the scale of these programs. Much of the recent debate has addressed the question: if we eliminate poverty programs, will poverty rise or fall? An equally, if not more, important question is: if we reduce spending on poverty programs, will poverty rise or fall? These questions may not have the same answers.

The essential distinction is between the overall, or average, effects and the effects of a small change, or marginal effects. As economists have long been aware, marginal and average effects can differ greatly,

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

Edgar K. Browning is Professor of Economics at Texas A&M University, and William R. Johnson is Associate Professor of Economics at the University of Virginia. The authors thank William A. Niskanen for his helpful comments.

not only in magnitude but also in direction. Moreover, for most practical purposes, the marginal effect of doing a little more or a little less is what is relevant. It is unlikely that social programs will be eliminated, but changes in their scales are frequently made, and the marginal effects are relevant in evaluating these changes.

In this paper we investigate the effects of a change in the scale of redistributive tax and transfer programs. More specifically, we focus on the marginal cost to the rest of society of changing the income of the poor. It should be emphasized that finding that this cost is substantial, as we do, does not necessarily imply that the amount of redistribution should be reduced. Marginal cost is only one side of the equation; the other side is the marginal benefits perceived when the poor are helped or a more equal distribution of income is produced. People can be expected to differ over how much they believe greater equality is worth. Nonetheless, the cost of achieving more equality is clearly an important consideration: a person may favor more redistribution when it costs $1.25 to raise the income of the poor by $1 but favor less redistribution if it costs $10 to achieve that result.

A Trade-off between Equality and Efficiency

Popular discussions of egalitarian policies often implicitly assume that income transfers are costless from a social point of view. In other words, one person's income can be increased by $1 by reducing another person's income by $1; total income remains unchanged. This conceptualization of the process would be valid (neglecting administrative and compliance costs) if incomes were unaffected by the policies used to redistribute income. In this setting, the total income pie is fixed and redistribution is a zero-sum game whereby one person's gain exactly equals another's loss. When redistribution is viewed in this way, it is understandable that ethical and moral judgments become the primary considerations.

Economists have long been aware, however, that a redistribution of income, by severing the link between effort and reward, can dull the incentive to earn income. Thus, they speak of a trade-off between equality and efficiency; that is, greater equality may come at the expense of a lower total income for the community. Put in a different but more revealing way, if an expansion in redistributive policies leads some people to decide to earn less income, then the cost to the nonpoor of increasing the income of the poor by a dollar will be greater than one dollar.

A key empirical question, then, is how much tax and transfer programs affect the supply of productive resources and hence the size of the total income pie. Twenty years ago, available evidence suggested that the effect of public policies on labor supply and saving was negligible, small if not actually zero. In recent years the use of more sophisticated statistical techniques and better data has increasingly led economists to conclude that adverse supply responses are significant. For example, studies of the data generated by field tests of the negative income tax form of welfare program in the 1970s have estimated that work effort of recipients would fall by perhaps 10 to 20 percent. This finding is relevant to a number of actual welfare programs that are similar in structure to the negative income tax. At a more aggregate level, a major survey of studies of all types of government transfer programs hazarded the conclusion that all these programs together had reduced national labor supply by about 4.8 percent (Danziger, Haveman, and Plotnick 1981).

Suppose we tentatively accept the conclusion that transfer programs have reduced labor supply by roughly 5 percent; does this imply that the efficiency cost of policies designed to reduce income inequality is small? Many people would probably view a 5 percent reduction as a small price to pay for the welfare and income support system we have. In fact, most economists seem to concur. As Danziger (1982, p. 18) states: "[I]t should be stressed that while income transfer programs create disincentives to work and save, the magnitude of these disincentives is relatively small. They pose no threat to the overall efficiency of the economy."

The major purpose of this paper is to suggest that this sanguine conclusion misinterprets the significance of disincentive effects for evaluating the cost of reducing economic inequality. We do not dispute the magnitudes of the disincentive effects most researchers have found; in fact, our analysis is based squarely on their findings. Instead, we argue that disincentive effects of the size generally found imply that the cost to the rest of society of raising the income of the poor is quite high.

The fact that the overall effect of taxes and transfers on labor supply and saving is small, if true, does not tell us much about the relevant cost of reducing economic inequality. There are two reasons for this. First, as pointed out earlier, the cost relevant for decision making is the marginal cost. A 5 percent reduction in labor supply due to current transfer programs is a measure of total cost or, if expressed relative to some base, of average cost. Average cost, however, is generally not a good guide to marginal cost; in the present case, marginal cost is certain to be greater than average cost.

An example will clarify this point. Imagine increasing the tax rate on labor earnings from zero to 100 percent. At 100 percent, a worker gets to keep none of his earnings, so labor supply will typically fall to zero at or before this point. This does not, however, imply that labor supply will fall by 40 percent when the tax rate is 40 percent (as it is for many households today). Common sense as well as empirical evidence tells us that the reduction is much smaller. An 8 percent reduction, for example, represents an average reduction of 2 percent for each 10 percentage points in the tax rate. This, however, does not mean that increasing the tax rate by another 10 percentage points will reduce labor supply by only 2 percent: Since labor supply will fall to zero when the rate reaches 100 percent, the reduction in labor supply beyond some point must become much larger than 2 percent. It seems reasonable to suppose that each successive 10-percentage-point increase in the tax rate will depress labor supply by more than the previous increment. This would then describe a situation where the marginal reduction in labor supply is greater than the average reduction. Consequently, focusing on the total or average effects of tax and transfer programs will normally understate the responses produced by a small change in these policies.

The second reason why a small total reduction in labor supply does not necessarily imply that the marginal cost of reducing inequality is low is that the disincentive effect (the reduced labor supply) is not properly related to the income gains and losses of transfer recipients and taxpayers. The aggregate reduction in labor supply does not tell us what the marginal cost of increasing the incomes of low income households will be. Clearly, if we know that labor supply will fall by X percent following a certain policy change, that is related in some way to the marginal cost, but the exact relationship is not obvious. It turns out, as we show below, that a seemingly moderate change in labor supply can imply a surprisingly high marginal cost.

Marginal Tax Rates, Productive Incentives, and Redistribution

It is important to understand how tax and transfer programs tend to undermine incentives to earn income. One important way such programs affect productive incentives is through the application of high marginal tax rates to earnings. Seeing why incentives are affected requires distinguishing carefully between marginal and average tax rates.

Consider a worker with $30,000 in earnings, and suppose the government wishes to collect $7500 in taxes from him. As a first approximation, it could do this by exempting $20,000 (so taxable earnings are $10,000) and applying a constant tax rate of 75 percent to taxable earnings. If the worker continues to earn $30,000, his average tax rate is 25 percent ($7500/$30,000), but his marginal tax rate is 75 percent, since any change in earnings from the current level is subject to the 75 percent rate. Note that it is the marginal tax rate—not the average amount of earnings taken in taxes—that gives the worker less incentive to work. It does this by reducing the net wage rate received by the worker for changes in the amount he works. In this case, should the worker earn $1000 less, his disposable income falls by only $250. In effect, a 75 percent marginal tax rate reduces the net wage rate at the margin to one-fourth of its before-tax level. It pays less to work, and the higher the marginal tax rate the lower is the net rate of pay.

In addition to taxes, government transfers to low income households also often impose marginal tax rates on the earnings of recipients, by relating benefits to the level of earnings. If the transfer a person receives is reduced when earnings are increased, then this reduction in benefits has exactly the same effect as a marginal tax rate applied to earnings. Suppose, as in the food stamp program, that the transfer is reduced by $0.30 for each dollar earned. When earnings rise by $10, disposable income only goes up by $7, the same as if a 30 percent marginal tax rate is applied to earnings.

Therefore, to evaluate how taxes and transfers affect incentives, it is important to consider how high marginal tax rates are under present programs. This is difficult to establish because the relevant marginal tax rate is the combined rate that results from all the separate taxes paid and/or transfers received, so it will differ by income level and even among households at the same income level. In recent research, however, we have developed estimates of the average effective marginal tax rates for different income classes of households using 1976 data (see Browning and Johnson 1984). Although there have been several changes in tax and transfer policies since 1976, we do not believe current marginal rates would be significantly different on balance. For the lowest income class, containing the 20 percent of households with the lowest incomes, the average marginal tax rate was 54.4 percent. Most of this rate is attributable to the benefit reduction rates for transfers received, and some households receive transfers from more than one program. For the next four income classes from lowest to highest, each containing 20 percent of households, our estimated marginal tax rates are: 47.1 percent, 40.8 percent, 38.8 percent, and 44.6 percent.

Marginal tax rates at these levels can be expected to adversely affect incentives to work and save, but, as mentioned earlier, it is possible that the total effect would be relatively small. The more relevant question, however, is how a small change in the amount of redistribution will affect incentives to earn for both taxpayers and transfer recipients so as to determine the marginal cost of reducing economic inequality. A small increase in transfers and taxes from their present level will obviously increase marginal tax rates and thereby aggrevate disincentive effects. But what is probably not obvious is how much marginal tax rates will rise in comparison with the share of national income that is transferred from upper to lower income groups.

Suppose taxes and transfers were increased in such a way that the increment in marginal tax rates is the same for all persons. Under these conditions, to redistribute 1 percent of national income from upper to lower income households increases everyone's marginal tax rate by approximately 5 percentage points. To see why this happens, assume that income from all households with above average income is transferred to all households with below average income, and that average income is $30,000. To collect 1 percent of national income in taxes from households earning over $30,000, we must take more than 1 percent of their combined incomes, since the combined incomes are less than national income. But there is a more important reason why the marginal tax rate on upper income households will be greater than 1 percent: if only above average incomes are taxed, then only that portion of income in excess of the average can be taxed.[1] Thus, taxable income for a household earning $40,000 would be $10,000, or the earnings in excess of $30,000, and to collect just 1 percent of this household's total income requires a marginal tax rate of 4 percent on its taxable income.

For a similar reason, to redistribute 1 percent of national income to households with below average incomes means that the transfer program must embody a marginal tax rate of about 5 percent. To restrict transfers to those with low incomes, the transfer must decline as income rises until until the transfer is zero at an income of $30,000.[2]

---

[1] It is often suggested that the total incomes of high income households could be taxed, while not taxing low income households at all. This procedure, however, encounters a serious problem. Suppose that those earning above $30,000 were required to pay a tax of 10 percent of their total incomes while those earning less pay no tax. A person earning $33,000 would actually have a higher disposable income by reducing his earnings to just below $30,000 and avoiding the tax. In other words, such a policy creates a strong incentive for those just above $30,000 to reduce their incomes to below that level.

[2] If all households with incomes below $30,000 were given the same transfer, say $1000, this would mean a person earning $30,500 could increase his disposable income by reducing his income below $30,000 to quality for the transfer.

The required benefit reduction rate, or marginal tax rate, would be 5 percent. This necessary benefit reduction rate is the main reason why low income households now face such high marginal tax rates. Even though the lowest two quintiles receive a net redistribution that is probably no more than 5 or 6 percent of national income, their marginal tax rates are typically close to 50 percent, over half of which is due to the benefit reduction rates embodied in transfer programs.

Of course, the exact way an increased redistribution raises marginal tax rates depends on the particular changes made in tax and transfer policies, and it is not necessary for everyone's tax rates to rise by the same amount. But the major point—that marginal tax rates rise more than the percentage of national income redistributed—remains valid. We might, for example, choose to redistribute income to those with incomes below $15,000 and tax those with higher incomes. In this case, a redistribution of 1 percent of national income might increase marginal tax rates of recipients by perhaps 10 percentage points, higher than the previous case because the same volume of transfers must be tapered off more rapidly as income rises (a higher benefit reduction rate) so that the transfer falls to zero at $15,000. For taxpayers, the increment in marginal tax rates might be only 3 percent because now income in excess of $15,000 can be taxed. In general, when 1 percent of national income is redistributed, if the increment in marginal tax rates for some people is kept below 5 percentage points, this will necessitate increases for other people greater than 5 percentage points.

A Hypothetical Example

In this section we use a simple numerical example to illustrate how the various factors discussed above interact to determine the marginal cost of increasing the income of low income households. In Table 1, we assume that society is composed of five households with labor earnings as shown in column 2. Initially, each household is assumed to confront a marginal tax rate of 40 percent under current tax and transfer policies. (Exactly how much each household initially pays in taxes or receives in transfers has no bearing on our problem except insofar as they combine to produce the 40 percent marginal tax rate.) What we propose is to increase slightly the marginal tax rate in a way that redistributes income in favor of low income households. Specifically, we assume that the marginal tax rate on total earnings is increased by 1 percentage point, and the additional tax revenue produced is returned as equal per household transfers. On

TABLE 1

EFFECTS OF A CHANGE IN REDISTRIBUTIVE POLICY

Household (1)	Initial Earnings (2)	Change in Earnings (3)	Net Additional Tax Revenue[a] (4)	Transfer (5)	Net Transfer (6)	Change in Disposable Income (7)
A	10,000	–50	80	240	160	110
B	20,000	–100	160	240	80	–20
C	30,000	–150	240	240	0	–150
D	40,000	–200	320	240	–80	–280
E	50,000	–250	400	240	–160	–410
Total	150,000	–750	1,200	1,200	0	–750

[a] These figures are rounded to the nearest $10.

balance, this will redistribute income in favor of households with below average incomes.

We also need to specify how the households' labor supply, and hence earnings, will respond to the higher marginal tax rate. We therefore assume the elasticity of labor supply with respect to the net wage rate is 0.3 for all workers. The labor supply elasticity simply indicates the percentage change in labor supply divided by the percentage change in the net wage rate. An elasticity of 0.3 thus means that a 10 percent reduction in the net wage rate will result in a 3 percent reduction in labor supply.

Any labor supply elasticity should be interpreted as the average response of a large number of people, some of whom may respond either more or less than the amount predicted by that elasticity. Furthermore, workers can respond to changed incentives in several ways: changing hours worked per week, vacation days, time of entry into the labor force, time of retirement, moonlighting, or intensity of effort on the job. Obviously, many of these changes will be apparent only in the long run as workers change jobs, new workers enter the labor force, or unions alter their bargaining demands.

The actual effects of our incremental redistributive policy depend significantly on the size of labor supply responses, as indicated here by the elasticity. Our choice of 0.3 reflects the available empirical evidence in the economics literature. While there is certainly no consensus that the exact value is 0.3 (interpreted as an average of the different elasticities of different groups of workers), most economists would view it as a reasonable figure in light of available evidence.[3] In any case, the implied reduction in labor supply is not implausibly large. Indeed, our intention is to show how a moderate reduction in labor supply translates into a surprisingly high marginal cost of raising the incomes of low income households.

When the marginal tax rate rises from 40 to 41 percent, the net wage rate falls from 60 to 59 percent of its before-tax value, a reduction of 1.67 percent. The percentage reduction in labor supply is thus 1.67 percent times the elasticity of 0.3, implying that labor supply will decline by 0.5 percent. Assuming that earnings decline in proportion to labor supply, the reductions in gross earnings are shown in column 3 of Table 1.

---

[3] For a recent survey of empirical studies, see Hansson and Stuart (forthcoming). For simplicity, the numerical example developed here assumes that uncompensated and compensated labor supply elasticities are equal: labor supply is taken to depend only on the marginal net wage rate, effectively ignoring income effects. The empirical results presented in the next section, however, are based on an analysis that accounts for income effects.

The additional tax revenue collected from each household is shown in column 4. Tax revenues do not rise by 1 percent of total earnings when the tax rate is increased by 1 percentage point. When earnings fall by $750, the government loses $300 in revenue under its initial 40 percent marginal tax rate, so the 1 percent increase in the marginal tax rate only adds $1200 to revenue rather than $1500. This illustrates one reason why the initial level of marginal tax rates is relevant: the higher the rates, the greater the revenue loss from any reduction in earnings caused by a change in tax or transfer policy.

The additional tax revenue is returned to households as transfers of $240, shown in column 5. The figures in column 6 are the difference between the transfer received and the additional tax paid. On balance, our policy transfers $240 from households D and E to households A and B. (The amount redistributed, $240, is about one-sixth of 1 percent of total income, but marginal tax rates had to rise by a full percentage point to accomplish that redistribution.) This transfer, however, does not indicate how the disposable incomes of households are affected, since each household's own earnings have fallen in response to the policy. The change in disposable income is given by the sum of the net transfer and the change in earnings, with the results shown in column 7. Overall, disposable income falls by $750, which equals the reduction in total earnings caused by the labor supply reduction.

A small expansion of taxes and transfers therefore raises the disposable income of household A by $110 and reduces the disposable incomes of the other households by $860. In other words, the marginal cost of raising the income of the poorest household by $1 is about $8. We believe that this is the appropriate way to look at the effects of a change in redistributive policy since the gain—$1 to the poor—is weighed against its cost—$8 to the nonpoor. As noted above, the magnitude of the marginal cost does not tell us whether it is desirable to expand or curtail redistribution, but it does present the consequences in a way that makes a more informed judgment possible. This hypothetical example illustrates the point that a moderate disincentive effect can imply a surprisingly high marginal cost associated with reducing income inequality. In the next section we show that this conclusion remains valid when actual data on U.S. households are used rather than hypothetical figures.

Before proceeding, however, it is necessary to consider further the specific type of policy change that is used in Table 1 and in our simulations discussed below. This analysis has been criticized as biased toward finding a high marginal cost because we assume that transfers are made not only to the poor but also to the nonpoor (see column 5). In response, we would make two points.

First, the assumption that everyone pays taxes and receives transfers is used to simplify the calculations in our example; the policy need not work in exactly this way. It is important to recognize that our tax-transfer policy is equivalent to a negative income tax that restricts transfers to those with below-average incomes and finances these transfers with taxes that fall exclusively on those with above-average incomes. For example, the government could simply make the transactions recorded in column 6. In this case, there would be a benefit reduction rate (marginal tax rate) for transfer recipients of 1 percent up to an income of $30,000, and a marginal tax rate of 1 percent on earnings above that level; each person's marginal tax rate would rise by 1 percentage point as before, so labor supply would be affected in exactly the same way as in our example. This avoids having everyone pay taxes and receive transfers, but the results are the same as in our example.

In our example the nonpoor receive transfers, but that feature is not essential to the redistributive policy we are analyzing; it is merely an accounting procedure that simplifies the exposition and arithmetic. In practice, we would not expect most actual changes in redistributive policies to involve transfers to everyone. Nevertheless, our hypothetical redistributive policy is still capable of evaluating such policies if their net effects are similar to those shown in column 6.

Second, we have studied the actual pattern of taxes and transfers in the United States and compared the net transfers at each income level to those implied by our hypothetical policy. We found that the average effect of all taxes and transfers on the distribution of income is similar to the distributional effects produced by our hypothetical policy. In other words, a proportionate expansion in all taxes and transfers would produce distributional results much like our policy. This result is perhaps the most important reason for believing that our hypothetical policy can serve as a reasonable proxy for an actual expansion or contraction in the scale of redistributive policies in the United States.

Thus, we think examining the effects of changing the distribution of income using our hypothetical policy provides a good indication of the actual cost of redistributing income. Of course, a different type of policy might perform better, and in the Appendix we explore such a possibility by examining, in the context of the same five-person society as in our example, a policy that restricts transfers to those earning below $20,000 and collects taxes from those with incomes above that level. We found that the marginal cost is about 10 percent less than in the example discussed here. This, along with other policies we have examined, suggests that the hypothetical policy emphasized here is not likely to misrepresent the effects of actual redistributive policies to any significant degree.

Marginal Cost and Labor Supply Responses

Using data from a representative sample of about 50,000 U.S. households in 1976, we employed computer simulation techniques to calculate the marginal cost of reducing economic inequality. A 1 percentage point increase in marginal tax rates on labor earnings was assumed to be added to the actual system of taxes and transfers, and the revenues returned as equal per capita transfers, as in our previous numerical example. The ultimate effects on disposable incomes were worked out under a variety of assumptions regarding labor supply responses.

Some of the results are presented in Tables 2 and 3. Households were ranked according to income and grouped into quintiles, each containing 20 percent of all households. Thus, quintile one contains the poorest 20 percent of households and quintile five contains the wealthiest. Table 2 gives the results for four different assumptions about the size of labor supply responses. We regard the benchmark case, with its elasticity of 0.31, as best supported by available evidence. Labor supply elasticities, however, are difficult to estimate with any degree of accuracy, as illustrated by the range of estimates found in the literature. Thus, we also performed the simulations for higher and lower assumed values for the labor supply elasticity.[4] Finally, for purposes of comparison, we calculated the effects when there was no change in labor supply.

The results in our benchmark case are similar to the hypothetical example discussed earlier. A small expansion in redistribution that raises everyone's marginal tax rate by 1 percentage point leads to an increase in the average disposable incomes of households in the two lowest quintiles (but primarily in the lowest quintile) and to a reduction for the upper three quintiles. Per dollar of additional income for the lowest two quintiles combined, the marginal cost to the upper

---

[4] As a technical note regarding our modeling of labor supply responses, two points should be made. First, the elasticities are economy-wide average figures; in our formulation, each household's elasticity depends on its marginal and average tax rates, and so the elasticities vary among households. Second, the figures in Tables 2 and 3 are the compensated labor supply elasticities. The corresponding uncompensated elasticities are 0.2, 0.31, and 0.05 for the benchmark, high elasticity, and low elasticity cases, respectively. For more detail about the technical aspects of our work, see Browning and Johnson (1984).

TABLE 2

CHANGES IN DISPOSABLE INCOME PER HOUSEHOLD

Case	Elasticity	Quintile 1	2	3	4	5	Marginal Cost
Benchmark	0.31	36.49	7.54	−43.15	−108.17	−267.49	9.51
High Elasticity	0.47	25.23	−15.13	−76.46	−150.65	−324.95	22.48
Low Elasticity	0.21	45.73	25.60	−16.41	−71.63	−211.82	4.20
No Response	0	64.48	62.69	32.54	−22.82	−136.89	1.0

SOURCE: Browning and Johnson (1984, Table 6).

three quintiles is estimated at $9.51. In our benchmark case, we thus find that it costs the nonpoor about ten dollars to raise the income of the poor by one dollar when labor supply responses are taken into account.

Predictably, the results depend strongly on how large the labor supply response is. With an elasticity of 0.47 (implying that a 10 percent reduction in net wage rates results in a 4.7 percent decline in labor supply), marginal cost is more than double the benchmark case. For an elasticity of 0.21, it is less than half the benchmark case. Since we do not know with any precision how large labor supply responses will be, we also cannot determine exactly how large the marginal cost really is. In our view, however, Table 2 suggests that marginal cost can be surprisingly high even when labor supply responses are quite modest.

The results of the redistribution when everyone continues earning the same income are presented in the last row of Table 2. In this case, marginal cost is, of course, equal to $1. Of greater interest is how the gains and losses for quintiles vary from the zero elasticity case to the others. The gain to the two lowest quintiles together is twice as large in the zero elasticity case than in the low elasticity case, and three times as large as in the benchmark case. Therefore, studies that simply calculate gains and losses without taking labor supply effects into account greatly overstate the extent to which an increase in redistribution raises the incomes of the poor.

These figures all pertain to changes in disposable money income and would not accurately reflect how the well-being of households is affected. This is because people are working less and consequently have more leisure time. For example, in the benchmark case, the average household in the lowest quintile gains $36.49 in money income and also has more time available for nonwork pursuits, so the gain in money income alone understates the total benefit of the policy. Table 3 provides estimates of the changes in real income per household; these figures add to the change in money income an estimate of the value of the additional leisure time gained when labor supply falls, using the net wage rate to value time. The marginal cost of increasing the real income of the poor is lower when this adjustment is made.

Of the two measures of marginal cost—one based on money incomes and the other incorporating the value of leisure—which is the relevant one to consider? Most economists would emphasize marginal costs reckoned to include the value of time, because they believe all gains and losses—not just changes in spendable income—should be counted. For that reason, the estimates in Table 3 give a better

TABLE 3

CHANGES IN REAL INCOME PER HOUSEHOLD

Case	Elasticity	Quintile 1	2	3	4	5	Marginal Cost
Benchmark	0.31	47.30	32.60	−11.49	−71.59	−196.21	3.49
High Elasticity	0.47	38.55	18.07	−30.32	−93.45	−222.00	6.11
Low Elasticity	0.21	56.12	45.85	3.46	−56.80	−185.071	2.29

SOURCE: Browning and Johnson (1984, Table 8).

indication of the size of the trade-off between equality and efficiency, since our concept of efficiency recognizes time as a scarce resource.

But insofar as our goal in redistributing income is to increase the consumption of goods and services by the poor, the estimates in Table 2 are more relevant. Poverty is usually identified with a lack of such material things as food and housing, and it is the level of money income that largely determines consumption. Since the government's poverty lines are based on money income and take no account of how much or whether people work, a concern over the level of money incomes alone is indicated. Therefore, we conclude that both measures of marginal cost provide useful information.

Marginal Cost Including Savings Responses

The estimates discussed above incorporate only the effects of reduced labor supply, but there are other ways that tax and transfer policies may contribute to the high cost of helping the poor. For example, there are collection, administrative, and enforcement costs associated with raising tax revenues and dispensing transfers. These costs also enter as a wedge between the benefit to recipients and the burden on taxpayers, and incorporating these costs would further increase the marginal cost (but not by a great deal, we suspect). The focus in this section is on yet another potentially important cost: the cost of a change in redistribution on the level of private saving.

An increase in the amount of redistribution is likely to reduce saving for two reasons. The first is well known and is based on the belief, which has some empirical support, that the well-off save more (at the margin) than do the poor. Taking a dollar from a wealthy person might reduce his saving by 20 cents, while the recipient of that dollar might spend it all, implying that total saving falls by 20 cents. The second and more important reason is based on our earlier analysis. Since redistribution lowers the total income of the community (because of the labor supply reduction), saving can be expected to fall even if the marginal propensity to save out of income is the same for the poor and the nonpoor. These two points together strongly suggest that increased redistribution will depress the level of saving.

But why is a reduction in saving a cause for concern? Under certain circumstances, it would not be. Specifically, if the tax on labor income is the only distortion in an otherwise competitive economy, whether people respond to a reduction in income by cutting saving or consumption is irrelevant to the determination of the cost of helping the poor. In this case, a person who saves receives the entire gain associated with providing funds that finance capital formation. If the interest rate is 5 percent, then an additional dollar in saving can finance capital that (net of depreciation) will augment future production at an annual rate of return of 5 percent. A reduction in saving means that the saver sacrifices future consumption, but the sacrifice is equal to the future production the saving would have made possible. Thus, if a $1 reduction in income led to a $1 reduction in saving, only the saver bears a cost, and that cost will be correctly measured as $1.

The situation is different, however, if the government intervenes in the operation of capital markets by levying taxes on capital income. In the United States, several taxes fall on the return to capital, notably corporate income taxes, property taxes, and personal income taxes. The combined effect of these taxes is to make the rate of return received by the saver less than the rate of return actually generated when that saving finances capital investments. For example, a recent study (Feldstein, Poterba, and Dicks-Mireaux 1981) has estimated that the before-tax real return to capital in the corporate sector averaged about 10 percent in the 1970s, but after taxes savers received a real rate of return that averaged about 3 percent. In other words, the return to corporate capital was taxed at a rate of about 70 percent. Although tax rates on capital income are somewhat lower today, we will use these figures to illustrate how a change in saving is relevant to the marginal cost of redistribution.

With a before-tax return of 10 percent and an after-tax return of 3 percent, consider what happens when a person saves less, and assume that the principal would have been held intact in the future and only the net return consumed. If saving declines by $1, the person sacrifices a stream of interest payments of $0.03; that sacrifice is borne by the saver himself. But there is also a sacrifice of a stream of future tax payments of $0.07 per year, and that cost is borne by people other than the saver, presumably by whomever would have benefited from the expenditure of those tax revenues. Consequently, if redistribution causes saving to decline, a tax on the return to saving imposes costs in the future on people other than those whose saving falls. This cost takes the form of reduced capital income tax revenue, and it is not taken into account in our earlier estimates.

Exactly how this cost should be measured is a complex theoretical issue, but we can explain why this cost is likely to be large. The net (after-tax) rate of return of 3 percent can be taken as a measure of how much future benefits are discounted: a benefit of $1.03 one year in the future has a present value of $1.00. When saving falls by $1, as in the example above, society loses a stream of annual benefits of $0.10 ($0.07 of which would have gone to the government and $0.03

to the saver). The present value of an infinite stream of annual benefits of \$0.10 when discounted at the 3 percent rate is \$3.33 (\$0.10/.03). Thus, when saving falls by \$1, the present value of the future costs is \$3.33; one dollar of this is the cost borne by the saver himself and the other \$2.33 represents the present value of lost future tax revenues. In this example, a reduction of \$1 in saving actually imposes costs on people other than the saver of \$2.33.

The above calculation is a simplified example of what economists call the shadow price of capital. It is intended to measure the present value of future sacrifices produced when saving (and hence real investment) falls by \$1. The shadow price, therefore, is the real social cost of a reduction in saving. The actual calculation would take into account how long the principal is held intact and the extent to which some of the net return to the saver may additionally be saved in the future. In a recent survey of issues related to the calculation of the shadow price of capital, Lind (1982) concludes that 3.80 is a reasonable estimate. This estimate is based on the assumption that the tax rate on capital income is 54 percent. We use Lind's estimate of the shadow price of capital in the following discussion.

Now consider how the cost of reduced saving, as measured by the shadow price of capital, influences the marginal cost of helping the poor, using the benchmark case from Table 2. The marginal cost of raising the incomes of the bottom two quintiles by \$1 (\$0.83 for the lowest and \$0.17 for the second) was a loss of \$9.51 to the top three quintiles. Suppose that only the top three quintiles save and that their marginal propensity to save out of disposable income is 20 percent. Then a decline of \$9.51 in income implies a reduction of \$1.90 in saving. The cost of this reduction in saving is \$3.80 per dollar of saving, or \$7.22. Of this, we have already counted \$1.90 as the loss to the savers, but that leaves an additional cost of \$5.32 to be allocated.

It is not clear who will actually bear this cost, but since it takes the form of reduced tax revenues, presumably the losses result from lower government spending in the future. This raises the further question of how the benefits of government spending are distributed among income classes. The distribution for total government spending is unknown, but we do have estimates of how government expenditures on transfers are distributed among income classes. The lowest quintile receives about 21.7 percent of all transfers.[5] If we assume that the lowest quintile will bear 21.7 percent of the unallocated cost of reduced saving, the cost on the lowest quintile is $1.15. When this is combined with their gain in current income of $0.87, the overall effect is a reduction of $0.28. The reduction for the second quintile would be larger.

---

[5] This figure may seem low, but it should be pointed out that the lowest quintile of households contains only 11.5 percent of all persons, so 21.7 percent represents a per person transfer of nearly twice the average. Moreover, such programs as social security, medicare, and unemployment insurance, which involve large transfers to the nonpoor, also work to keep the percentage low.

Note carefully what this implies: an expansion in redistributive policies of the sort described reduces the incomes of not only the nonpoor but also the poor, when the present value of future losses is included. Conversely, a reduction in redistribution would actually benefit the poor under these conditions.

We do contend that this is necessarily the outcome. Obviously, the actual effects depend on labor supply responses, savings responses, tax rates on labor and capital, and other factors, many of which are not known with accuracy. What we have shown, however, is that plausible assumptions about the relevant magnitudes imply that redistribution at the margin may actually harm the poor. Even if this extreme result is not correct, it should be clear that, when the effects of reduced saving are incorporated, the marginal cost of raising the incomes of the poor is likely to be much higher than the estimates of the last section that evaluated only the labor supply responses.

The Time Pattern of Gains and Losses

Our finding that redistribution at the margin may harm both the nonpoor and the poor may seem reminiscent of conclusions drawn from supply-side economics using the Laffer curve. In particular, some supply-siders have argued that a reduction in tax rates would increase tax revenues (and therefore benefit everyone) because the lower rates would so stimulate the supply of productive services. Our analysis is related to this view to the extent that we also stress the importance of effects on the supplies of labor and capital. But there is a difference: for the extreme supply-side outcome to occur, resource supplies must increase sharply when tax rates are reduced, but our analysis assumes much smaller responses. For example, for a reduced tax rate on labor income to yield more revenue, as some supply-siders have suggested it would, it has been calculated that the labor supply elasticity would have to be in the 1.5 to 2.5 range, well beyond the value most economists find plausible. In our benchmark case, we assume the labor supply elasticity is only 0.31. In fact, the most important implication of our analysis is the finding that seemingly moderate responses imply that marginal cost is quite high.

Exactly how the poor may be harmed by an expansion of redistributive taxes and transfers can be better understood by considering how the effects would unfold over time. In the discussion above, we discounted the future costs and expressed them in present value terms. We also assumed that labor supply adjusted immediately when marginal tax rates rose. The timing of the responses, however, suggests that the short-run, or temporary, effects will be quite different from the long-run, or ultimate, effects.

Suppose, for example, there is a small expansion in redistributive programs. Since it takes time for people to adjust their work habits to a change in circumstances, the immediate effect would be a small change in labor supply. Since earnings fall very little, savings would also decline very little at first. The short-run effect, therefore, will be to raise the incomes of the poor, and the marginal cost to the nonpoor would initially be only slightly greater than one dollar, ignoring subsequent future effects. But as people adjust their labor supply, the benefits to the poor fall and the costs to the nonpoor rise. In addition, as saving is lower year after year, the cumulative effect on the stock of capital grows and tax revenues from capital income taxes fall progressively further below what they would otherwise have been. Government spending on transfers will probably grow more slowly as a consequence, further harming the poor and the nonpoor in the future.

By distinguishing between short-run and long-run effects, we can see why it is virtually certain that an expansion in redistribution will at least temporarily raise the incomes of the poor. But the benefits gradually dissipate over time and the costs rise, until in some future year the poor may have incomes that are no higher than if the initial expansion had never taken place, and in later years have even lower incomes. It is also important to recognize that the adjustment process can take quite a long time. Studies have found that it may take from 2 to 4 years for half the eventual change in labor supply to occur following a change in wage rates. It will take even longer—perhaps 20 to 25 years—before the full effects of reduced saving on capital income tax revenues are realized. Thus, the immediate effects of a change in redistributive policy can be expected to be quite different, and appear much more favorable, than the ultimate effects.

This difference between the short-run and long-run effects of changes in the amount of redistribution suggests how society might inadvertently embark on a course that ultimately harms the poor who are the intended beneficiaries. If the political process tends to emphasize the short-run effects of policies, welfare programs could be extended to the point where the marginal effects are actually harmful to the interests of the poor themselves. This could be true even if the actual consequences are known; when they are not known and are as difficult to evaluate accurately as the analysis here may suggest, the possibility of an overexpansion in welfare programs cannot be dismissed. Again, we do not argue that this has actually occurred, but there is no doubt that a tendency to stress the immediate effects of welfare policies inclines public policy in that direction.

Conclusion

The relevant cost of helping the poor through redistributive tax and transfer programs of the sort now commonly used is likely to be quite high. Moreover, there is the possibility that further efforts to raise the incomes of the poor will be counterproductive, especially if a long-run point of view is taken. If one's conception of a good society includes an adequate standard of living for the poorest households, these are distressing implications. But two qualifications to these conclusions should be kept in mind.

First, our analysis has been concerned exclusively with the cost of a particular type of redistributive tax and transfer policy; a different type of redistributive policy could result in substantially lower costs. For example, there may be identifiable subgroups among the poor (for example, disabled persons) whose labor supply responses may be nonexistent or considerably lower than our assumed average response. The cost of targeting welfare aid on such groups would be less than the cost of aiding low-income people generally.

Second, redistribution is not the only way the incomes of the poor can be increased; another way is through economic growth. If real per capita income grows at a rate of 2 percent per year, in nine years income would be 20 percent higher. This is a larger gain than can probably be accomplished through increased redistribution, and it can occur without increasing the tax rates on the poor or the nonpoor. Thus, one of the implications of our analysis is to strengthen the case for economic growth as a way to reduce poverty. This is not to suggest that increasing the rate of economic growth is an easy matter, but there are steps the government could take in this direction.

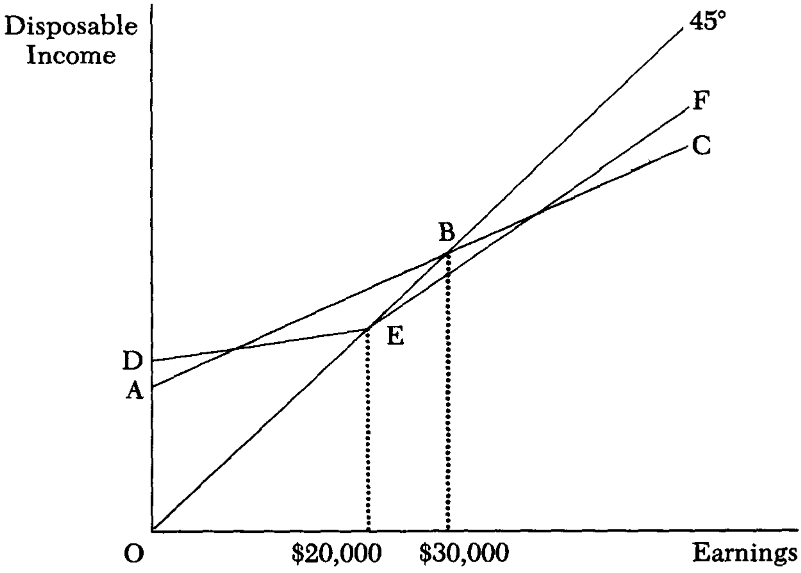
Economic growth as an antipoverty policy has fallen into disfavor in recent years, in part because it is believed that the poor do not reap significant benefits from it. The basis for this belief is that many of the poor have low or zero earnings; a person with no earnings is not directly benefited when economic growth raises real wage rates. What this argument ignores, however, is that economic growth makes it possible to finance larger transfers without raising marginal tax rates. Insofar as expenditures on transfers are kept a constant proportion of national income, growth in national income benefits recipients of transfers proportionately as much as it benefits other people. Economic growth therefore may be a better antipoverty policy than attempts to redistribute a larger share of national income.

Appendix

In this appendix, we modify the numerical example in the text to evaluate the marginal cost of redistributing income using a different policy than the one developed earlier. Figure 1 can be used to contrast the two policies graphically. Earnings of households are measured horizontally and disposable incomes are measured vertically. The 45-degree line illustrates the situation before the incremental redistributive policy is adopted; for simplicity, it is assumed that there are no preexisting tax or transfer policies, so earnings equal disposable incomes. The hypothetical policy examined in the paper then produces the relationship ABC. Disposable incomes are raised above earnings for those with earnings below $30,000 (they receive net transfers), while disposable incomes are reduced for those with higher incomes (they pay net taxes). Schedule ABC shows only the combined effects of the tax and transfer programs, and, as the diagram illustrates, the net effect is the same as a negative income tax applied to those with incomes below $30,000, with taxes collected from those

FIGURE 1

ALTERNATIVE REDISTRIBUTIVE POLICIES



with incomes above. The marginal tax rate is indicated by (one minus) the slope of ABC. Since ABC is a straight line, the marginal tax rate is the same for transfer recipients and taxpayers. In our example, the marginal tax rate was 1 percent.

As an alternative redistributive program, let us consider a policy that restricts transfers to those with earnings below $20,000 and redistributes approximately the same amount of income. For transfer recipients, the relationship becomes DE, with larger transfers going to those with the lowest incomes; note that the marginal tax rate is higher now for low income households because the transfers must be tapered off more quickly to reach zero at $20,000 rather than $30,000. For taxpayers, the relationship becomes EF, showing that a lower tax rate can be used for taxpayers in this case when income in excess of $20,000 is taxed rather than income in excess of $30,000. Basically, this policy is simply another negative income tax, but one where the break-even level of income (the earnings level where the transfer is zero) is $20,000 rather than $30,000.

To evaluate whether this alternative policy involves a lower marginal cost, we use the same assumptions employed in the numerical example in the text (see Table 4). The one important point not shown explicitly in Table 4 is the increment in marginal tax rates. It was assumed that a 1 percent tax was applied to earnings above $20,000. By requiring that the government's budget be balanced (additional tax revenues sufficient to finance the additional transfers), we determined by trial and error that the marginal tax rate for those with incomes below $20,000 would be 2.2 percent.

Faced with an increase of 2.2 percentage points in their marginal tax rates, households A and B reduce their earnings by more than in the example in the text, as shown in column 3. The reductions for C, D, and E are the same because their marginal tax rates rise by 1 percentage point in both cases. The net effect on tax revenue for each household is shown in column 4: note that tax revenues fall for A and B because their initial marginal tax rates were 40 percent and their earnings fall. Total additional net revenue is $228, and this is distributed as transfers to A and B, as shown in column 5. The net transfer, the sum of columns 4 and 5, is shown in column 6. Finally, the change in disposable income, the sum of columns 6 and 3, is shown in column 7.

Households B, C, D, and E have their disposable incomes reduced by a total of $1086 with this policy, while household A has its disposable income increased by $156. This translates into a marginal cost of $6.96. Thus, the marginal cost to the upper four households of increasing the disposable income of the poorest household is just

TABLE 4

AN ALTERNATIVE TAX-TRANSFER POLICY

Household (1)	Initial Earnings (2)	Change in Earnings (3)	Net Additional Tax Revenue (4)	Transfer (5)	Net Transfer (6)	Change in Disposable Income (7)
A	10,000	−110	−44	222	266	156
B	20,000	−220	−88	6	94	−126
C	30,000	−150	40	0	−40	−190
D	40,000	−200	120	0	−120	−320
E	50,000	−250	200	0	−200	−450
Total	150,000	−930	228	228	0	−930

under $7, compared with the $7.82 marginal cost for the policy evaluated in the text. In this example, which concentrates transfers more completely on the lowest income households, the marginal cost is about 10 percent.

The important point suggested by this example is that the marginal cost is not likely to be significantly different for policies that may appear to be quite different from the one on which we based the estimates in the text. Although one example does not prove this general point, we have experimented with several other policies with the same results. Thus, we believe that the estimates of marginal costs presented in the paper are likely to be reliable indications of the general order of magnitude involved.

References

Browning, Edgar K., and Johnson, William R. "The Trade-off between Equality and Efficiency." *Journal of Political Economy* 92 (April 1984): 175–203.

Danziger, Sheldon; Haveman, Robert; and Plotnick, Robert. "How Income Transfers Affect Work, Savings, and the Income Distribution." *Journal of Economic Literature* 19 (September 1981): 975–1028.

Danziger, Sheldon. "Poverty and Inequality Under Reagonomics." *Journal of Contemporary Studies* 5 (Summer 1982).

Danziger, Sheldon, and Gottschalk, Peter. "The Poverty of *Losing Ground*." *Challenge* 28 (May/June 1985): 32–38.

Feldstein, Martin; Poterba, James; and Dicks-Mireaux, Louis. "The Effective Tax Rate and the Pretax Rate of Return." Working Paper no. 740, National Bureau of Economic Research, 1981.

Hansson, Ingemar, and Stuart, Charles. "Tax Revenue and the Marginal Cost of Public Funds in Sweden." *Journal of Public Economics* (forthcoming).

Lind, Robert C. "A Primer on the Major Issues Relating to the Discount Rate for Evaluating National Energy Options." In *Discounting for Time and Risk in Energy Policy*. Edited by R. Lind et al. Washington, D.C.: Resources for the Future, 1982.

Murray, Charles. *Losing Ground*. New York: Basic Books, 1984.

TRANSFERS, EQUALITY, AND THE LIMITS OF PUBLIC POLICY

James Gwartney and Richard Stroup

The debate about the merits of the redistributive state generally focuses on the proper trade-off between more income equality and more total income. The questions are familiar. What is the optimal distribution of income? How much inequality should a just society accept? How much economic growth should we sacrifice in order to promote the welfare of the poor and disadvantaged? Of course, transfer programs go well beyond the poor. They are aimed variously at farmers whose crops have failed or whose crops "should" sell for more, at governments of nations whose people are worthy of aid, at corporations that employ many workers and are in financial trouble, and at innumerable other entities.

The proposition that transfer policies promote the welfare of targeted groups is generally accepted. Taxes, transfers, and regulatory policies are perceived to be adjustment levers available to fine-tune the economic machine that grinds out goods and services. If we do not like the allocation of economic benefits, corrective action can be undertaken by moving the levers via the political process.

We believe this view of the transfer society is naive. Taxpayers and transfer recipients are human beings, not sheep who can be shorn at will, their wool automatically growing back for the next shearing season. People will adjust their actions for individual advantage, in response to governmental changes in the rules of the game. Similarly, since the political process, like the market, results from individual choices, it may or may not yield its stated goals. Thus, it is not obvious that income transfers emanating from the political process will promote economic equality or even help the targeted groups.

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

James Gwartney is Professor of Economics and Policy Sciences at Florida State University. Richard Stroup is Professor of Economics at Montana State University, and Research Director of the Political Economy Research Center in Bozeman, Montana.

This paper investigates the expected impact of transfer activities. Section I utilizes public choice theory to analyze the political attractiveness of various types of transfers. Section II focuses on the shortcomings of annual income as a vehicle with which to differentiate between the poor and nonpoor. Section III considers the need to ration transfers and investigates the effects of various rationing mechanisms on the expected actions of recipients, and on their gains. Sections IV, V, and VI focus on the unintended side effects of transfers, which often reduce their effectiveness. The concluding section presents empirical evidence on the impact of transfers on economic equality and poverty.

Transfer activities come in many forms. Some involve direct payments to recipients, either in money or in-kind benefits such as food, medical services, or housing. There are, however, other forms of transfers: Price supports, entry restraints, price ceilings, tariffs, quotas, and subsidies transfer wealth just as surely as direct income transfers. Thus, when we speak of transfer activities we include a broad range of policies intended to increase the economic welfare of various subgroups at the expense of others in society.

I. Public Choice and Politically Attractive Transfers

The political process is widely perceived to be more egalitarian than market allocation. In a democratic setting political votes are equally distributed (one person, one vote), whereas market allocation results in unequally distributed income (consumer votes). However, public choice theory indicates the situation is considerably more complex than the equality of political votes implies.

Just as self-interest is a powerful motivating force in the marketplace, so, too, it is in the political arena. There is little evidence that politicians are an unusually altruistic class of citizens. But even if they were, competition would force them to consider primarily votes when making political choices. Politicians who stake out positions and support policies that maximize their chances of winning elections have a competitive advantage relative to those who place other things (for example, economic efficiency or the interests of groups with little political power) above votes. Survival in the political marketplace forces politicians to support policies that enhance their electoral prospects.[1]

---

[1] On the economics of public choice, see Tullock (1976), Lapage (1978, chaps. 5 and 6), Gwartney and Stroup (1983b, chaps. 4, 29, and 30), and Olson (1971).

What types of transfer activities will help a politician win elections? Public choice theory indicates that three major classes of transfers are likely to be politically attractive.

1. *Transfers from many unorganized individuals to concentrated groups of well-organized individuals.* A special interest issue is one that generates substantial personal benefits for a small group of constituents while spreading the cost widely over a large number of other voters. A few benefit a great deal individually, whereas a large number lose a little individually from any particular transfer program.

There are two main reasons why transfers of a special interest nature will be attractive to vote-conscious political entrepreneurs. First, special interest beneficiaries will feel much stronger about the issue than other voters. Many special interest voters will vote for or against politicians almost exclusively on the basis of this issue. Since the issue is of personal importance, special interest voters are also likely to be better informed on the special interest issue and more likely to convince others to vote for favored candidates. In contrast, non-special interest voters are unlikely to be strongly enough affected even to know much about the issue, particularly if it is packaged so as to conceal the source of the small personal cost imposed on the broad cross-section of voters.

Second, special interest groups provide an important source of campaign workers and financial support. Money and volunteer workers are the life-blood of politics. Information designed to create a positive image must be supplied to voters who have little incentive to invest time and personal resources studying candidates and issues. This requires printed materials, newspaper advertisements, television commercials, and campaign workers. Individuals with intense feelings who belong to an easily identifiable, well-organized interest group provide a potential supply of essential political resources.

2. *Transfers from future to present voters.* Policies that provide easily observable, current (before the next election) benefits at the expense of future costs that are difficult to identify will also be attractive to vote-conscious politicians. The pre-election benefits will enhance the image of the politician with the voters on election day. In contrast, post-election adverse effects that are difficult to identify will exert little negative impact. Economists refer to this bias as the shortsightedness effect.

Predictably, a pattern of current benefits relative to future costs will enhance the attractiveness of a transfer policy. Future costs will often go unseen. Future taxpayers who are currently too young to vote will not influence today's election, and therefore politicians have little incentive to support their interests.

The shortsightedness effect helps explain the popularity of several transfer programs that clearly reduce the size of the economic pie. For example, the adverse effects of rent controls on rental housing will be observable only in the future. Further, much of the negative impact will be against people who later want to move into the geographic area—people who clearly have no vote now. Similarly, an increase in the minimum wage will provide easily observable current benefits (a higher wage rate), but the negative side effects on new hires, total employment, and training opportunities will be experienced primarily in the future.

3. *Transfers from the poorly informed and politically inactive to the better informed and more politically skilled.* In the political arena, power is related to information, participation, and political skills. Politicians who cater to the interests of uninformed individuals who seldom vote will be at a disadvantage relative to those who represent the interests of informed citizens who vote regularly. Similarly, politicians have an incentive to cater to the views of the politically persuasive. Persons with persuasive skills, organizational abilities, and financial resources will exert a disproportionate influence on the political process.

Implications for Transfer Policy

Given the nature of the political process, there is little reason to believe that egalitarian transfers will be very attractive to political entrepreneurs. Although the poor are a concentrated group, they are not very well organized. They are less likely to vote than persons with higher income. As Table 1 shows, only 36 percent of the population age 18 and over living in households with less than $12,500

TABLE 1

VOTER PARTICIPATION BY INCOME GROUPINGS, 1984

Household Annual Income	Percent of Voting Age Population	Percent of Voters in 1984 Election	Percent of Persons Age 18 and Over in Income Group Who Voted, 1984
Less than $12,500	24	16	36
$12,500 to $24,999	27	29	56
$25,000 to $34,999	19	22	62
$35,000 to $49,999	17	19	60
over $50,000	13	14	58

SOURCES: *New York Times/CBS Poll* (*New York Times*, 8 November 1984), and U.S. Department of Commerce, *Money Income of Households, Families and Persons in the United States: 1983.*

of income voted in 1984, compared to nearly 60 percent for the rest of the population. The voter participation rate for unemployed workers has consistently been only about two-thirds of the rate for employed workers.[2] Survey data also indicate that low-income and unemployed voters are more likely to be uninformed (or misinformed) on both issues and candidates than other voters. Uninformed voters with a relatively low voter participation rate are unlikely to use the political process effectively.

Of course, the political process rewards different skills and attributes than market allocation. However, there is little reason to expect that the poor will possess relatively more of the communication and organizational skills that are rewarded handsomely by the political process. In fact, the entrepreneurs and managers in a politically dominated society are likely to be the same people who would excel under market organization. The people with good ideas, creative minds, and more energy will rise to the top in most any society, the business world, or the political arena.

The theory of public choice suggests that successful politicians tend to support programs that aid organized special interests more than programs that help the poor. The empirical evidence is consistent with this theory. Table 2 indicates various categories of direct cash and noncash transfers for 1965, 1975, and 1983. The data illustrate that most income transfers are not directed toward the poor. Counting both cash and noncash benefits, means-tested transfers were $78.1 billion in 1983, compared to total direct income transfers of $475.6 billion. Thus, transfers directed toward the poor account for only 16 percent of the total. If indirect transfers (those not involving government checks) emanating from tariffs and other trade restrictions, occupational licensing, and other regulatory programs were counted, the share of transfers directed toward the poor would be even smaller. The bulk of transfer benefits are intended to help politically active groups such as farmers, the elderly, business, and organized labor. The same intelligence, energy, and organizational

---

[2] The *Statistical Abstract of the United States, 1982–1983* (Table 805) reports the voter participation rates for employed and unemployed workers during the 1972–80 period:

Year	Employed (%)	Unemployed (%)
1972	66.0	49.9
1974	46.8	28.8
1976	62.0	43.7
1978	46.7	27.4
1980	61.8	41.2

TABLE 2

GROWTH OF TRANSFER PAYMENTS, 1965–83
(BILLIONS OF 1983 DOLLARS)

Type of Benefit	1965	1975	1983
Means-Tested (total)	23.2	70.2	78.1
Cash Assistance[a]	17.7	33.4	27.8
Noncash Benefits[b]	5.5	36.8	50.3
Nonmeans-Tested (total)	125.4	298.9	397.5
Social Security (OASI)	51.9	97.4	151.4
Social Security (DI)	4.9	13.7	18.7
Medicare	—	25.5	52.7
Unemployment Compensation	7.6	22.9	25.5
Farm Price Supports	16.0	3.4	21.8
Other	45.0	136.0	127.4
Total Transfers	148.6	369.1	475.6

[a] Includes Aid to Families with Dependent Children, general assistance, Supplemental Security Income, and means-tested veteran's pensions.

[b] Includes food stamps, school lunches, public and subsidized housing, and Medicaid.

SOURCES: U.S. Department of Commerce, Bureau of the Census, *Estimates of Poverty Including the Value of Noncash Benefits: 1984; Statistical Abstract of the United States;* and *Economic Report of the President, 1985.*

skills that enable one to earn money also enable one to be successful in the political arena.

II. Income Is a Poor Measure of Economic Status

Who should receive transfer payments? Annual income is used to qualify persons for means-tested transfers and determine the proportion of one's income allocated to the tax collector. The ability of means-tested transfers financed by progressive taxation to redistribute income from the rich to the poor depends on the reliability of annual income as an indicator of economic status. If annual income is not an accurate measure of economic status, then transfers based on income will often go to the nonpoor. Similarly, high tax rates intended for the rich will often be paid by the nonrich. Under such circumstances, even taxes and transfers designed to promote equality will be relatively ineffective.

Unfortunately, annual income is not a very accurate indicator of economic status (Lilla 1984). First, life-cycle factors reduce the accuracy of annual income as a measure of economic status. Most people have low incomes when they are young (and in school) and when they are old (and in retirement). In contrast, incomes are generally much higher during the prime working years. Annual income, therefore, is often a misleading indicator of economic status. The annual income of both the young who are acquiring skills and the old who are in retirement generally understates their economic well being. During this phase of their life cycle, many nonpoor individuals qualify for various types of means-tested transfers. In contrast, during their prime working years many individuals and families—who are far from rich—will earn incomes that place them in very high tax brackets. This is particularly true for dual income families seeking to provide for the welfare and education of their children.

Second, cost-of-living differences among geographic areas further erode the usefulness of income as a measure of economic status. In recent years, studies indicate that the cost of purchasing the typical bundle of goods and services consumed by a family of four is approximately 30 percent more in New York and Boston than in Atlanta or Dallas. Once again, annual income is only a crude measure of economic well being.

Third, money income ignores the contribution of nonmarket time. Modern economic theory emphasizes that enjoyment of most commodities depends on both market goods and the nonmarket time (Becker 1965; Becker and Michael 1973). Many commodities such as watching television, reading books, hunting, fishing, playing games, and listening to music require relatively more nonmarket time than market goods. Nonmarket time may also be used to produce goods directly (food, clothing, laundry service, child care, etc.) that others may purchase with market income. To the extent households with higher money incomes have proportionally less nonmarket time, money income data overstate their relative well being.

How important are differences in nonmarket time? In recent years, the top fifth of family income recipients have contributed more than 30 percent of the total weeks worked, compared to only 8 percent for the bottom quintile. Among high income husband-wife families in 1983, more than three-fifths (62.9 percent) of the wives worked in the paid labor force, compared to 37.8 percent of the wives in middle income families and only 14.7 percent of the wives of low income families. The differences in full-time market participation of working wives were even greater. Full-time working wives characterize 47.0 percent of the high income families, compared to 28.5 percent of the middle income families and only 6.7 percent of the low income families. Therefore, the wife was seven times more likely to work full-time in high income families as compared with low income families. Clearly, high income earners work more and have less nonmarket time than those with less income. Yet, the money income data ignore the contribution of nonmarket time to family living standards. This deficiency further limits the ability of money income to accurately classify the economic status of individuals and families.

Given the loose relationship between annual income and economic status, there will be a great deal of slippage even when taxes and transfers are linked to income. Annual income will often categorize families as rich (and therefore impose heavy taxation) when closer inspection reveals that they are less well off than many others who are taxed less heavily. Similarly, annual income will often place families among those eligible for means-tested transfers even when their economic status is significantly higher than others who are ineligible.

III. The Rationing of Transfers: Eroding the Gains of Recipients

In a world of scarce resources, a government that supplies transfers must limit their size and restrict their availability. Otherwise, the quantity of transfers demanded will far exceed the ability of the government (and the economy) to supply them. Transfers must be rationed. Stated another way, restrictive criteria must be adopted to limit the demand for transfers.

The restrictive criteria accompanying transfers usually limit the options of recipients. For example, means-tested transfers require recipients to limit their income. Rent controls benefit recipients of low-cost housing only if they continue renting the same apartment even when they have changed jobs or retired. Unemployment benefits are linked to continued nonemployment status. These restrictions, which are a necessary element of transfer programs, often impose costs on transfer recipients. Thus, the net gain of the transfer recipient will be less than the size of the transfer. This will be true even in the case of cash transfers.

The most common rationing methods tie the receipt of transfer benefits to something the recipient owns, does, or is. Potential recipients have an incentive to adjust their affairs so as to increase the likelihood and size of personal transfer benefits, but such adjustments are costly. Indeed, most people will forsake the potential transfers because the costs of qualifying are greater than the benefits. Others will perceive that the expected value of the transfer income exceeds the costs of meeting (or continuing to meet) the restrictive criteria. They will choose recipient status. The rationing mechanism used to allocate transfers will influence both the size and distribution of the recipient's net gain. We next consider the three common rationing devices.

Rationing Transfers Via Ownership of a Tradable Asset

Suppose you are the owner of an asset that promised to provide $100 of income each year into the future. The market value of the asset is the discounted present value of the future income stream. You can sell the asset for this amount. For example, an interest rate of 10 percent means that the market value of $100 in annual income forever is $1,000.

When transfer benefits are tied to the ownership of an asset, the market value of the asset expands to reflect the present value of the expected transfer income stream. In effect, new owners purchase the transfer income stream when they purchase the asset to which the income stream is tied. Several current transfer programs fall into this category. For example, the agricultural price support programs provide a transfer benefit (in the form of above free-market prices) tied to ownership of allotments based on the acres of various crops planted during a prior-based period. In effect, the acreage allotment is a license to sell (to the government if necessary) at a price higher than the opportunity cost (net of the license fee) of production. In the case of feed grains, the allotments are linked to specific farms. Thus, one must buy a farm in order to buy the accompanying allotment. In this case, the value of the allotment gets capitalized into the market value of agricultural land. In the case of tobacco and peanuts, limited trading of the allotments without the land is permitted. The allotments trade for market prices reflecting the flow of income one can expect from production and sale of the products at the artificially high support price. Landowners, not farmers as such, benefit.

This method of rationing transfers is not limited to agriculture. Many cities license taxicabs and limit their supply, driving up taxi fares. The higher fares permit owners of taxi licenses to receive a transfer in the form of an income stream that reflects the higher fares and limited entry into the taxi business. However, as in the case of agricultural allotments, the present value of the expected future transfer income gets capitalized into the value of the licenses (medallions). In cities where the number of licenses is restricted, the license often sells for $50,000 and up.

In some cases, entry into occupations is limited via tradable licenses. On the West Coast, several states limit the number of licensed maritime pilots and require ships above a certain size to be brought to harbor by a state-licensed maritime pilot. The supply restrictions permit the maritime pilots to command extremely high wages.

However, the additional income in the form of the high wages of pilots will be reflected in the market value of the license. As is the case of taxi operators, qualified maritime pilots pay huge sums for these licenses.

When transfers are tied to the ownership of a tradable asset, the beneficiaries are the owners of assets to which the transfers were tied at the time the policy was instituted (or unexpectedly increased in attractiveness from the viewpoint of recipients). The transfer policy created a windfall gain for these individuals. The primary beneficiaries of long-standing transfer programs are dead and gone.

Continuation of these transfer programs in the expected manner does nothing to improve the economic status of the current recipients. Essentially, the current recipients paid for the transfers when they bought the license, allotment, or other asset to which the transfer is tied. As long as the current transfer program continues at the anticipated level, receipt of the transfer does not influence the profitability (or expected rate of return) of transfer recipients. Only unanticipated policy changes will affect the current recipients.

Our analysis indicates why such transfer programs are difficult to repeal. Ending the program would impose a once-and-for-all reduction in the value of the asset to which the transfer is tied and for which the current owner typically has already paid. Current recipients have a strong incentive to oppose repeal or a reduction in transfer benefits even though they do not gain (net of what they paid) from the transfers. We are caught in a transitional gains trap (Tullock 1975).

Rationing Transfers by Requiring the Recipient to Perform an Action

In this case, transfers are restricted to those who perform certain qualifying actions—for example, waiting in line, passing a test, working in a specified occupation or industry, completing detailed forms, or winning the approval of political authorities. Persons will seek the transfers when the perceived gain from a transfer exceeds the expected cost of qualifying.

To understand how this method of rationing transfer benefits works, consider the following simple case. Suppose the government offers a $20 bill to any person who waits continuously in line for two days at the U.S. Department of Treasury. This transfer program would have a finite cost. Only a limited number of persons would perceive that the benefits of the transfer were worth the costs. Persons with the lowest opportunity cost of waiting in line would be the primary beneficiaries of the program. However, the net gain of most beneficiaries would be considerably less than $20. If an individual's opportunity cost of waiting in line two days at the Treasury were $12, his net gain would be only $8. If his opportunity cost were $19.90, the net gain would only be 10 cents.

This simple example highlights the problem that arises when recipient action is used to ration transfers: resources expended seeking to qualify for the transfer consume a substantial portion of the transfer's value. At the margin, the opportunity cost of qualifying will completely eliminate the expected gain from the transfer. Unlike a cash price, which utilizes no resources and benefits the seller as much as it costs the buyer, the in-kind price generally benefits no one. The resources utilized and convenience sacrificed produce nothing, but are simply means to compete or qualify for benefits. Thus, when this method of rationing transfers is used, the cost of transfers generally far exceeds the net gain of receipts.

What current programs require recipient action as a condition of receiving the transfer? Many state and local governments require new entrants into such occupations as electrician, contractor, realtor, and undertaker to pass a stiff entrance examination primarily designed to restrict supply. Large fees are often charged to take the test or receive an operating license. Since such requirements restrict entry, persons in the occupation are able to obtain a transfer in the form of above free-market prices (or wages) for their services. To qualify for the transfer, however, one has to have a license. Persons who expect the gain from the above-market wages to exceed the opportunity cost of the license will expend the resources to obtain the transfer. The opportunity cost of "earning" the license (for example, study time, waiting to take the test, completing necessary forms, paying required fees, etc.) will consume a substantial portion of the transfer benefits.[3] In this case, there may be gains to society from the activities, if they make the applicants more qualified to perform the tasks of a licensee. However, unless the activities are fully justified by such gains, the recipient's *net* transfer gain will be less than the cost of the transfer.

There are many other cases where recipients are required to "earn" the transfer. Craft apprenticeship programs generally require individuals to work for a long period at below-market wage rates before qualifying for the restricted entry wage rates available to journeymen.[4] The opportunity cost of the former erodes much of the benefit derived from the latter. Filing complex documents, enduring lengthy delays, and meeting business structural requirements are distinguishing characteristics of low-interest government loan programs. To a large extent, these procedures are merely sophisticated methods of rationing transfers via the waiting-in-line criteria.

---

[3] Supporters of occupational licensing often argue that stiff licensing requirements eliminate unqualified persons and thereby improve the quality of workmanship in the occupation. Detailed studies of several occupations fail to support this dubious proposition. The case of construction crafts is interesting because workmanship is often inspected. Nonetheless, licensing continues in craft occupations.

The homesteading period of American history illustrates the operation of this method of allocating transfer benefits. Not wanting to ration western lands to the highest bidders, the government decided to give it away. Of course, this necessitated a method of rationing. The government chose to give a plot of "free" land to the first person who established a legal claim, erected a structure, and lived on the land for a designated period of time (usually five years). In order to get the transfer, homesteaders had to be willing to "wait in line" for the development of a transportation and distribution network that facilitated gains from specialization and exchange. A predictable result of this method of allocation was severe hardship, as persons seeking the transfers settled the land well before it was economically beneficial to do so.

To see the problem more clearly, consider a hypothetical parcel of land not worth farming in 1866, but expected to be worth $1000 in 1872, when transportation and local population would make it a break-even proposition to farm. Would there be competition to settle the land before 1872? Yes, because anyone waiting until 1872 would almost surely be too late. To settle in 1871 would be socially wasteful, since the labor and other resources needed to settle and farm the land would not produce as much as they would elsewhere. But because the land would be worth $1000 the following year, some people would be willing to suffer a year's losses to claim the land. How about settling two years in advance, in 1870? Again, if the wasted time, labor, and other resources would total less than the present discounted value of the land, we could predict settlement. Thus resources worth up to the entire value of the land might well be wasted by those competing to claim it first.

In fact, the situation was worse than we describe, because no one knew how difficult the years before the break-even point would be, when the break-even point would occur, or how much the land would really be worth afterward. So those most optimistic about low settlement costs, early profitability of farming the land, and greater land values thereafter would compete among themselves and settle even earlier than correct forecasts would have indicated. That is why only about 30 percent of all settlers in the first 30 years of the homestead program (which began in 1862) were able to survive long enough to obtain the land they settled (Stroup 1985, and citations therein). It is no accident that the legacy of western settlements is one of hardy men and women fighting what, for many, turned out to be a losing battle for survival. Essentially, these people were paying a dear price for the property right to a transfer benefit ("free" land).

---

[4] When occupational licensing is instituted (or increased in restrictiveness), current practitioners are nearly always excluded from the restrictive practices. They are grandfathered into the occupation, that is, they are granted positions at the front of the line. Only future practitioners have to wait in line (meet the restrictive requirement). The shortsightedness effect indicates why practices of this type have considerable political appeal.

Rationing the Transfers to Specified Subgroups

This method of rationing allocates limited transfers to persons who belong to a specified subgroup of the population. Current subgroups eligible for various transfers include: (1) persons with a disability, (2) unemployed workers terminated without cause from their previous position, (3) the poor, and (4) the elderly. Receipt of the subsidy depends on continued status as part of a specified subgroup.

These transfers are intended to reduce the hardship associated with such situations as unemployment, disability, or poverty. However, when the probability or duration of the situation is influenced by individual choices, the transfers encourage actions that place one in a subsidized subgroup. Thus, insuring against adversity over which individuals have some control actually promotes the occurrence of the situation. In the insurance industry this is called the "moral hazard problem," and private insurance companies seldom offer protection against adversities that are substantially affected by the behavior of potential claimants (in our case, transfer recipients).

There is one eligibility requirement for government transfer benefits that cannot be satisfied by a change in behavior: age. Moral hazard is therefore not a problem in programs for the elderly. This helps explain why for those over 65, but not for other groups, the poverty rate continued to decline as transfers increased during the last two decades. Nevertheless, some transfer programs limit the elderly's earning, and the expected transfers may influence their behavior when younger. But tying the benefits to age reduces the negative impacts.

IV. Markets Adjust to the Distribution of Transfer Gains

The economy is like a balloon. If you push it in one place, it bulges in another. Prices (terms of exchange) are constantly adjusting to economic and political change. When changing conditions reduce the attractiveness of earning opportunities in one area, people will shift to other more attractive options.

The rate of return equalization theorem underlies the movement of resources. This theorem indicates that once allowance is made for factors such as risk and nonpecuniary benefits, competition will tend to equalize the after-tax rate of return among earning opportunities. For example, investment project *A* cannot permanently yield a higher after-tax rate of return than *B*. If the net rate of return for *A* is higher than for *B*, with the passage of time *A* will attract investment funds from *B*, and thereby increase the return in *B* and depress it in *A*. The process will continue until equalization is accomplished. As long as individuals are free to decide how they are going to use their time, energy, and resources, they will reallocate resources so as to equalize, at the margin, after-tax rates of return across alternative opportunities.

The rate of return equalization theorem makes it clear that the person paying the tax bill may not bear the complete or even the primary burden of the tax. For students of tax incidence theory, this point is elementary. For example, the burden of an excise tax on gasoline falls primarily on consumers of the product, even though suppliers send the check to the Internal Revenue Service. Adjustments to a higher excise tax on gasoline will take resources away from the production and distribution of gasoline. In the long run, a reduction in supply will push gasoline prices upward until the remaining gasoline suppliers are once again able to earn, at the margin, a competitive rate of return. Thus, the primary burden of the tax falls on gasoline consumers in the form of higher prices.

A parallel analysis applies to transfers. As long as resources are mobile, transfers (subsidies) cannot permanently increase the rate of return of suppliers. To the extent the transfers improve profitability, resources will flow into the subsidized activity until some combination of lower product prices and higher resource costs restore the normal (market) rate of return. Thus, low interest loans cannot make farming or small businesses more profitable for long. Neither can tariffs nor quotas make protected industries more profitable in the long run. The best the transfers can do is create windfall gains, which competition will erode in the long run.

The rate of return equalization theorem also applies to investments in human capital and after-tax wage differentials. Wage differentials do not simply happen; they reflect the sacrifices associated with the acquisition of skills—the opportunity costs of education, training, and experience that lead to greater productivity and high wage rates in the marketplace. High wages also compensate individuals for less desirable working conditions such as long and inconvenient hours, intense job pressure, out-of-town travel, frequent locational moves, and living in less desirable areas. A structure of wage differentials will evolve that, after allowance for nonpecuniary and risk factors, equalizes the after-tax returns derived from alternative human capital investments.

A more progressive tax structure and an increase in transfers inversely linked to income can temporarily compress after-tax and transfer income differentials and the returns to human capital. With the passage of time, however, human decision makers will adjust their choices to the new incentive structure, and fewer individuals will make the sacrifices necessary to supply labor in occupational categories that are now taxed more heavily.[5] The supply of labor to the high taxable income categories will decline, causing wage rates to rise until the after-tax net returns in these areas are once again normal (equal to what can be earned on similar investments). In contrast, the lower taxes (and higher transfers) will increase the net after-tax returns in the low-tax occupations. More people will enter such occupations, thereby depressing wage rates and eventually restoring normal returns in the low-tax occupations. Once people adjust, the tax-transfer system will lead to larger before-tax earnings differentials than would have been present had the tax-transfer structure been less progressive (Wagner 1983, pp. 187–201). The adjustment process offsets the apparent egalitarian effects of the tax-transfer structure, at least partially.

V. Negative Side-Effects of General Transfer Programs

As we have emphasized, most transfers are not egalitarian, even in their purpose. Nonetheless, transfers alter the incentive structure in a manner that reduces the size of the economic pie. Two of the negative side effects—the impact of transfers on marginal tax rates and the encouragement of rent seeking—are particularly important. We now turn to an analysis of these two factors, which are a by-product of both egalitarian and non-egalitarian transfers.

---

[5] We use occupational categories here to represent many categories of productive behavior. Working more intensively, reliably, cooperatively, imaginatively, or using capital more productively are other ways, besides choosing a new occupation, in which an individual can be more productive in return for more pay. But when the added pay is taxed at a higher rate (or transfer payments are reduced) as a result, the incentive to be more productive is reduced.

High Marginal Tax Rates Reduce Incentives and Efficiency

An increase in the size of the transfer sector will lead to higher taxes. In turn, higher marginal tax rates reduce the incentive of individuals to earn and use resources wisely. When individuals are able to reap the benefit of their productive efforts, receipt of personal income induces them to help others and to engage in wealth-creating activities. However, when a substantial portion of their income is transferred to others, their willingness to engage in productive activity declines. Put simply, individuals are not nearly so willing to work and produce when they get to keep only 40 or 50 percent of what they earn. When marginal tax rates are high, lawyers, doctors, and other high income professionals predictably will spend more time on the golf course and consulting with their tax lawyers and accountants, and less time serving their clients.[6] Similarly, some secondary workers will decide that their jobs are not worth the effort when they get to keep only a fraction of every dollar earned.

Simultaneously, when marginal tax rates are high, individuals do not bear the full cost of tax deductible expenditures. Thus, high marginal tax rates make tax deductible expenditures cheap to the taxpayer-consumer, but not to society. The personal costs of tax-reducing expenditures such as business-related vacations, luxury restaurants, nice automobiles, plush offices, mortgage-financed homes and thousands of other deductible expenditures are substantially reduced by high marginal tax rates. However, deductibility does not reduce the true opportunity cost to society of the valuable resources used to produce these commodities. Since individuals bear only a fraction of the costs, they often choose the deductible goods and services even though the items cost more to produce than their value to the taxpayer-consumer. This process destroys wealth and wastes valuable resources. The result is a smaller output and slower economic growth.

Rent Seeking Wastes Scarce Resources

Rent seeking is a term used by economists to describe actions taken by individuals or interest groups designed to bring about legal changes that either directly or indirectly transfer income to themselves. The incentive to engage in rent seeking is directly related to the ease with which the power of the state can be utilized to transfer income and redefine property rights away from others, in favor of the rent seeker. When the tax-transfer policy of the government plays an important role in the allocation of income shares, substantial resources will flow into rent seeking. Resources that would otherwise be used to create wealth and generate income will be "invested" in rent seeking. In turn, increased use of the political process to gain transfer benefits will lead to defensive action by others seeking to protect their income and wealth from transfers.

---

[6] At first glance it may appear that higher taxes also have an income effect, reducing the taxpayer's income, and possibly causing more willingness to work, offsetting the negative incentive effect. However, for society as a whole, if the tax dollars are spent efficiently, then there are income gains to offset the taxpayer losses. In aggregate, a net income effect will be present only if recipients have a different response to an income change than taxpayers (see Gwartney and Stroup 1983a).

As Gordon Tullock (1967) and Terry Anderson and Peter J. Hill (1980, pp. 6–7) have pointed out, in terms of its impact on resource use, rent seeking is similar to theft. Both rent seeking and theft use valuable resources to transfer rather than generate income. Just as an increase in the incidence of theft causes individuals to purchase more burglar alarms, safety locks, and firearms, an increase in rent seeking will lead to more defensive actions designed to resist transfers. For both theft and rent seeking, the flow of resources into transfer (and protective) activities and away from productive activities is a negative sum game. It represents pure social waste.

The resources flowing into lobbying illustrate the growth of rent seeking (and defensive action) accompanying the expansion in the transfer sector during the last two decades. Between 1976 and 1983 the number of lobbyists registered with the federal government rose from 3,420 to 6,500, an increase of 90 percent in 7 years. As recently as 1979 New York had twice as many national trade associations as Washington, D.C. By 1983 the number of Washington trade associations exceeded New York by nearly 20 percent. A recent study found that 65 percent of the chief executive officers of the top 200 Fortune firms are in Washington on business at least once every two weeks, up from 15 percent a decade ago (Boaz 1983). When the political process makes transfers more likely, an increase in rent seeking is a natural by-product.

VI. Negative Side Effects of Means-Tested Transfers

Various transfers are means-tested in order to ration the benefits, to the extent possible, to the poor. We noted earlier that since income is a highly imperfect measure of economic status, a portion of even means-tested benefits will flow to the nonpoor. In addition, means-tested transfers will involve unintended side effects that will substantially reduce their effectiveness as an antipoverty weapon. Three of these side effects are particularly harmful.

1. *Since the high implicit marginal tax rates accompanying means-tested transfers severely retard the incentive of the poor to earn, the net increase in the income of the poor is much less than the size of the transfers.* We already noted the negative impact of high explicit tax rates on the incentive of the nonpoor to earn. The incentive of low income recipients to earn is adversely affected by high *implicit* marginal tax rates. Since the benefits derived from means-tested transfers decline with income, more earned income means fewer transfer benefits. Thus, the reduction in benefit levels as income increases confronts the poor with an implicit marginal tax rate. For individual programs, the implicit tax rate appears to be quite reasonable. For example, food stamp benefits are reduced by $30 for each $100 monthly earnings up to $800. The implicit marginal tax rates associated with cash transfer programs such as Aid to Families with Dependent Children (AFDC) and unemployment compensation are somewhat higher, typically in the 50 to 60 percent range. However, analysis of single programs conceals the true picture.

Most poor people who qualify for one program are also eligible for others. When the compound multiprogram implicit marginal tax rate is calculated, it is exceedingly high. A diverse set of studies indicates the families receiving benefits from AFDC (or unemployment compensation), food stamps, and Medicaid confront implicit marginal tax rates between 70 percent and 90 percent on the first $10,000 of earnings (Anderson 1978; Bethune 1985; Gwartney and McCaleb 1985; Laffer 1984). When poor families are permitted to keep only 10 to 30 percent of their additional earnings, clearly such high implicit marginal tax rates pose a significant disincentive to work and earn.

Traditional economic theory indicates that both the substitution and income effects of the transfers (that is, both lower net pay per hour and the extra income) will encourage the poor to reallocate time from market work to nonmarket activity including housework, leisure, and the underground economy. Many transfer recipients who would otherwise have engaged in market work will decide to work fewer hours, only on convenient jobs, or not at all. As a result, a significant portion of the transfer income is merely replacement income; it simply replaces income the recipient would have earned in the absence of the transfer. Thus, the money income of recipients increases by less than the amount of the transfer.

Is there evidence that transfers have influenced the work force participation of the poor? As Table 3 indicates, there has been a substantial increase in the proportion of poor household heads who do not work. By 1984 more than half (50.6 percent) of the poor households were headed by a person who did not work at all during

TABLE 3

INCREASING NUMBER OF POOR HOUSEHOLD HEADS WHO DO NOT WORK AT ALL

Families with Income Below the Poverty Level	1959	1966	1970	1980	1984
All Poor Households					
Householder Did Not Work at All During the Year					
Number (millions)	2.5	2.4	2.3	3.1	3.7
Percent of Poor Households	30.5	39.7	44.0	49.6	50.6
All Poor Female-Headed Households					
Householder Did Not Work at All During the Year					
Number (millions)	1.1	1.0	1.1	1.8	2.2
Percent of Poor Female-Headed Households	57.1	52.7	56.6	61.5	62.5

SOURCES: U.S. Department of Commerce, *Money Income and Poverty Status of Families and Persons in the United States: 1984* (Table 18): *Characteristics of the Population Below the Poverty Level: 1982* (Table 5): and *U.S. Statistical Abstract: 1968,* p. 330.

the year, up from 30.5 percent in 1959. One might think this increase merely reflects the increase in female-headed households among the poor, but such is not the case. The work force participation of poor female-headed households has also declined. The proportion of poor female household heads who did not work during the entire year jumped from 52.7 percent in 1966 to 62.5 percent in 1984. Thus, when the labor force participation rate of females was rising, more and more poor females were opting out of the work force. This is certainly consistent with the view that much of the transfer income was merely replacement for income that otherwise would have been earned, had the incentive structure not encouraged nonwork.

2. *Skill depreciation is a secondary effect of the decline in work force participation of the poor. With the passage of time, declining skills further limit the ability of the poor to escape poverty.* When the poor opt out of the work force, their skills tend to depreciate. Individuals who have not used their skills for extended periods of time find it difficult to compete with otherwise similar individuals who have continuous labor force participation. The long-term con-

sequences of an incentive structure that encourages nonwork is even more destructive than the short-term effects. As marginally poor people opt for nonwork, their work record deteriorates, and they become less and less able to support themselves. Even readjusting to a structured eight-to-five schedule, generally necessary for work force participation, may become difficult. As the length of time out of the work force expands, marginally poor individuals move into the hard core poor category.

If we do not institute a change in policy direction, what will happen to the 3.7 million poor household heads who did not work at all during 1984? Many of these people are capable of self-support. However, if we continue to allow even their limited skills to depreciate, they will soon face a hopeless situation. It is perhaps already too late for some. The nonwork trend illustrated by Table 3 is an ominous sign for the future.

3. *Families, churches, and private organizations reduce their efforts to assist the poor in response to an expansion in antipoverty transfers.* The best excuse to do nothing is the assurance that someone else is already doing the job. Predictably, private groups and individuals will do less when they think the government is doing more. During the 1960–80 period, millions of Americans perceived that increased government involvement relieved them of personal responsibility for the poor. Many churches even shifted from person-to-person assistance to lobbying the government for more funds for antipoverty programs. Just now, as the failure of government programs to alleviate poverty is more readily seen, we are beginning to see a reawakening of voluntary action. Increasingly, we are again beginning to see civic groups supporting soup kitchens and churches opening homes for children and missions for the homeless.

The assistance of families and friends is probably the most important form of voluntary assistance, but the nature of such assistance makes it virtually impossible to quantify. Table 4 presents data on the organized charitable giving of individuals, corporations, and foundations for the 1955–81 period, measured in 1981 dollars. Annual charitable giving for religious purposes more than doubled in real terms during this period. Private donations for education, health, and hospitals tripled during the same period. In contrast, charitable giving for social services (primarily for the poor) was virtually unchanged during the period. As a proportion of private charitable giving, contributions for social services fell from 23 percent of the total in 1955 to 10 percent in 1981 (Roberts 1984, pp. 139–40).

The decline in private assistance to the poor is particularly important because private charity has two major advantages relative to

TABLE 4

INDIVIDUAL, CORPORATE, AND FOUNDATION DONATIONS FOR SOCIAL SERVICES AND OTHER PURPOSES, 1955–81 (BILLIONS OF 1981 DOLLARS)

Year	Social Services	Religious	Education	Health & Hospitals	Other[a]
1955	5.2	11.3	2.5	2.0	1.6
1965	5.4	18.8	6.5	4.2	3.5
1975	5.3	21.8	6.7	7.5	8.9
1981	5.3	24.9	7.5	7.4	8.6

[a] Including arts and civic programs.

SOURCE: Roberts (1984).

government programs. First, private individuals and organizations have the capacity to structure help for the poor in ways that minimize the moral hazard problem and avoid harmful disincentive effects. Private aid can better be tailored to the specific needs of the individual or family and structured so as to elicit efforts by the poor to help themselves. Second, since the sacrifice of the donor is far more visible under voluntary charity, recipients are less likely to take the aid for granted and therefore are more likely to respond positively to it. Because of these strengths, private action to assist the poor can do more with fewer resources.

VII. Growth of Transfers, Equality, and Poverty

In the early 1950s direct cash transfers accounted for approximately 5 percent of personal income. Three decades later, the parallel figure had jumped to nearly 15 percent. Since the mid-1960s noncash transfers (primarily food, housing, and health care benefits) have grown far more rapidly than cash benefits. When cash and noncash transfers are considered, nearly 20 percent of the personal income in the United States reflects transfer policies. There can be little doubt that income transfers have grown rapidly, both in real dollars and as a proportion of personal income. Both means-tested and nonmeans-tested transfers have grown rapidly.

Does the growth of the transfer sector promote economic equality and hasten the decline of poverty? Two decades ago, most researchers would have considered this a trivial question. An affirmative answer was widely assumed. The more relevant question was thought to be "What is the proper trade-off between equality (transfers) and efficiency (growth)?"

Today we know that the issue is highly complex and that the answer is not obvious. Given the vast array of transfer programs, precisely isolating their impact on equality is nearly an impossible task. Contrary to the views of some, comparisons of the distribution of income before and after taxes and transfers shed little light on the topic. As we explained earlier, the pretax-transfer distribution would have been different without the programs.

Nonetheless, with the benefit of 20 years of economic experience, there is reason to question whether the growth of the tax-transfer sector has done much to promote equality. As Table 2 illustrates, a relatively small portion, less than 20 percent, of the direct cash and noncash transfers are means-tested (directed toward the poor). Given the imperfection of annual income as a measuring rod, no doubt some of the means-tested benefits accrue to persons and families who are relatively well-off. In addition, theory indicates that a significant portion of the means-tested transfers will be replacement income. The net increase in the income of the recipients will be less than the size of the transfer. Considering all of these factors, it is difficult to believe transfers have done much to promote economic equality.

Studies of changes in the after-tax and transfer distribution of income during the post–World War II era are consistent with this view. The most detailed study of this type was undertaken by Morgan Reynolds and Eugene Smolensky (1977). Rather than focusing only on taxes and a few transfer programs, Reynolds and Smolensky sought to isolate the distributional impact of a broad range of taxes, transfers, and expenditures. They found that despite a vast expansion in redistributive activities during the 1950–79 period, the degree of after-tax inequality was approximately the same at the end as at the beginning of the period. Summarizing their findings, the authors concluded: "It appears to be a common view that, even in a predominantly market economy, the distribution of income, however defined, is subject to government modification. We are not convinced that the conventional wisdom is correct" (p. 96).

Neither is there evidence indicating that transfers have done much to reduce the poverty rate, particularly for working-age Americans on whom the rationing restraints exert their greatest impact. As Table 2 illustrates, means-tested transfers grew rapidly during the 1965–75 period as the War on Poverty programs were put into place. The poverty rate of working-age Americans, which had previously been declining, started to rise during the period of rapid growth in means-tested transfers.

As Table 5 illustrates, the poverty rate of families fell from 32.0 percent to 13.9 percent between 1947 and 1965. The progress was

TABLE 5

OFFICIAL POVERTY RATE AND THE POVERTY RATE ADJUSTED FOR IN-KIND BENEFITS FOR FAMILIES BY AGE OF HOUSEHOLD HEAD, 1947–1982

Age of Household Head	1947	1959	1965	1968	1970	1975	1980	1982	1984
Per Capita Real GNP (1972 Dollars)	3,263	4,076	4,782	5,271	5,393	5,702	6,480	6,370	6,925
Official Poverty Rate									
Under 25	45.0	26.9	19.4	13.2	15.5	21.0	21.8	26.1	29.4
25–44	27.0	16.5	12.8	9.3	9.5	10.3	11.8	14.2	13.2
45–54	27.0	15.0	9.6	7.0	6.6	6.6	7.6	8.9	8.6
65 and over	57.0	30.0	22.8	17.0	16.5	8.9	9.1	9.3	7.3
All Families	32.0	18.5	13.9	10.0	10.1	9.7	10.3	12.2	11.6
Adjusted Poverty Rate[a]									
Under 25	—	—	19.0	12.3	14.2	18.7	18.8	24.0	26.8
25–44	—	—	12.5	8.6	8.5	8.5	9.5	12.3	11.4
45–54	—	—	9.5	6.7	6.1	5.8	6.2	8.0	7.4
65 and over	—	—	22.4	15.9	14.9	6.0	5.4	5.5	4.3
All Families	—	—	13.7	9.3	9.2	8.1	8.2	10.2	9.8

[a] The poverty rate adjusted for in-kind benefits is based on the recipient value method of valuing in-kind benefits.

SOURCES: The 1947 data are from *Economic Report of the President: 1964* (Table 7). Other data are from U.S. Department of Commerce: Bureau of the Census, *Estimates of Poverty Including the Value of Noncash Benefits: 1979 to 1982* and *Estimates of Poverty Including the Value of Noncash Benefits: 1984.*

across the board. The poverty rate of all age, racial, and family status groupings declined during the two decades following World War II. Table 5 indicates that, except for the elderly, the situation began to change in the late 1960s and early 1970s. The poverty rate for the elderly has declined consistently during the last four decades. The declining rate for the elderly pulled down the overall poverty rate and thereby helped to conceal the experience of working-age Americans during the 1970s. Thus, few observers have noticed that the official poverty rate for the nonelderly has been increasing since 1968.

For families headed by a householder under 25 years of age, the official poverty rate rose from 13.2 percent in 1968 to 21.8 percent in 1980. By 1984 the poverty rate of these youthful families had jumped to 29.4 percent, substantially more than the 1965 rate (19.4 percent). Similarly, the incidence of poverty among families headed by persons age 25–44 rose from 9.3 percent in 1968 to 11.8 percent in 1980 and 13.2 percent in 1984. Families headed by a person under age 45 now account for nearly two-thirds of the poor families in the United States. The poverty rate of households headed by a person age 45 to 54 also rose from 7.0 percent in 1968 to 7.6 in 1980 and 8.6 percent in 1984. Thus, reversing the trend of the 20 years following World War II, the official poverty rate of working-age Americans has been increasing during the last 15 years.

The official poverty rate considers only cash income. It does not take into account noncash (in-kind benefits such as food, medical service, and housing) transfer payments. Because the noncash benefits have grown so much more rapidly than cash transfers since the inception of the War on Poverty, some analysts have argued that the official rate is a misleading indicator of changes in the number of families living in poverty. Recent refinements by the U.S. Department of Commerce shed light on this issue.

The Department of Commerce now provides data on the poverty rate adjusted for noncash benefits for the 1979–84 period. Given the size of the noncash transfers and the impact of the in-kind benefits on the adjusted poverty rates in recent years, a poverty rate adjusted for noncash benefits can be reconstructed for earlier years.

Table 5 presents data on the adjusted poverty rate by age.[7] The

---

[7] The recipient value method values noncash transfers at the equivalent amount of cash income a recipient would be willing to exchange for the right to noncash benefits. Thus, it takes into account that recipients might rather have cash than the in-kind benefits. It is widely accepted by economists as the most appropriate method with which to impute a value to the noncash benefits.

1965, 1968, 1970, and 1975 adjusted data are reconstructed.[8] The data for the 1980s are from the U.S. Department of Commerce (1984, 1985). While the adjusted rates are lower, the time path pattern is quite similar to that for the official rate. Both the official and the adjusted rates show that the rate of poverty of the elderly declined sharply throughout the period. By 1984 the poverty rate of the elderly adjusted for noncash benefits had fallen to 4.3 percent, down from 15.9 percent in 1968 and 22.4 percent in 1965.

Once again, the picture is quite different for working-age families. Between 1968 and 1980 the adjusted poverty rate of families headed by a householder under 25 years of age rose from 12.3 percent to 18.8 percent. By 1984 the adjusted rate for this group reached 26.8 percent, well above the rate they experienced during the mid-1960s. For the largest age grouping (25–44), the adjusted poverty rate rose from 8.6 percent in 1968 to 9.5 percent in 1980 and 11.4 percent in 1984. The adjusted poverty rate for the 45–54 age grouping was also greater in the early 1980s than the late 1960s.

Thus, whether one looks at the official or adjusted poverty rates, the picture is the same. Soon after the massive increase in transfer payments in the late 1960s, the steady progress of the pre–War on Poverty era came to a halt and the poverty rates of working-age Americans began to rise. Thus, even though per capita real GNP rose throughout the postwar period (see Table 5), the growth of the last 15 years has not translated into gains against poverty among working-age Americans.

VIII. Conclusion

The impact of transfers on economic equality and poverty is far more complex than most people realize. It is not obvious that the political process will yield egalitarian transfers. And, even when it does, the net egalitarian impact may well be quite modest. Since annual income is a highly imperfect measure of economic status,

---

[8] Mathematically, the adjusted poverty rate within age group *a* for each year *i* is equal to:

$$APR_{ai} = OPR_{ai} - \frac{MTE_i}{MTE_{80}}(OPR_{a80} - APR_{a80})$$

where APR_{ai} = adjusted poverty rate during year i within age group a
OPR_{ai} = official poverty rate during year i within age group a
MTE_i = noncash, means-tested expenditures in year i
MTE_{80} = noncash, means-tested expenditures in 1980
OPR_{a80} = official poverty rate within age group a in 1980
APR_{a80} = adjusted poverty rate within age group a in 1980.

some slippage can be expected there. Predictably, market adjustments will erode some of the redistributive effects of egalitarian transfers. An expansion in transfers of any variety will encourage rent seeking and higher marginal taxes, both of which will retard aggregate output. In addition, means-tested transfers confront the poor with high marginal tax rates that reduce their incentive to earn. Thus, a portion of the transfer benefits is merely replacement income. Means-tested transfers also discourage participation in the work force and lead, with the passage of time, to skill depreciation, further reducing the ability of the poor to help themselves. Finally, public sector antipoverty programs tend to crowd out voluntary charity, which is more likely to be cost effective. Thus, when one considers structure and side effects of transfers, their apparent failure to promote equality and improve the economic status of the poor is not surprising.

References

Anderson, Martin. *Welfare: The Political Economy of Welfare Reform in the United States*. Palo Alto: Hoover Institution Press, 1978.

Anderson, Terry L., and Hill, Peter J. *The Birth of the Transfer Society*. Palo Alto: Hoover Institution Press, 1980.

Becker, Gay, and Michael, Robert. "On the New Theory of Consumer Behavior." *Swedish Journal of Economics* 75 (December 1973): 378–95.

Becker, Gary. "A Theory of the Allocation of Time." *Economic Journal* 75 (September 1965): 493–517.

Bethune, Jon J. "Marginal Tax Rates Confronting Low Income Families in Florida: Measures, Consequences, and a Proposal for Reform." Paper presented to the Southern Economic Association, Atlanta, 16 November 1984.

Boaz, David. "Spend Money to Make Money." *Wall Street Journal* (13 November 1983): Op-ed.

Gwartney, James, and McCaleb, Thomas S. "Have Antipoverty Programs Increased Poverty?" *Cato Journal* 5 (Spring/Summer 1985): 1–16.

Gwartney, James, and Stroup, Richard. "Labor Supply and Tax Rates: A Correction of the Record." *American Economic Review* 74 (June 1983a).

Gwartney, James, and Stroup, Richard. *Economics: Private and Public Choice*. New York: Academic Affairs, 1983b.

Laffer, Arthur B. "The Tightening Grip of the Poverty Trap." Cato Institute Policy Analysis no. 41. Washington, D.C., August 1984.

Lapage, Henry. *Tomorrow Capitalism*. LaSalle, Ill.: Open Court Publishing, 1978.

Lilla, Mark. "Why the 'Income Distribution' Is So Misleading." *The Public Interest* 77 (Fall 1984): 63–76.

Olson, Mancur. *The Logic of Collective Action*. Cambridge: Harvard University Press, 1971.

Reynolds, Morgan, and Smolensky, Eugene. *Public Expenditures, Taxes, and the Distribution of Income*. New York: Academic Press, 1977.

Roberts, Russell D. "A Positive Model of Private Charity and Public Transfers." *Journal of Political Economy* 92 (February 1984): 136–48.

Stroup, Richard L. "Buying Misery With Federal Land." Paper delivered at the Western Economic Association, Anaheim, California, 1 July 1985.

Tullock, Gordon, "The Welfare Costs of Tariffs, Monopolies, and Theft." *Western Economic Journal* 5 (June 1967): 224–32.

Tullock, Gordon. "The Transitional Gains Trap." *Bell Journal of Economics* 6 (Autumn 1975): 671–78.

Tullock, Gordon. *The Vote Motive.* London: Institute of Economic Affairs, 1976.

U.S. Department of Commerce. Bureau of the Census. *Estimates of Poverty Including the Value of Noncash Benefits: 1979 to 1982.* Washington, D.C.: Government Printing Office, 1984.

U.S. Department of Commerce. Bureau of the Census. *Estimates of Poverty Including the Value of Noncash Benefits: 1984.* Washington, D.C.: Government Printing Office, 1985.

Wagner, Richard. *Public Finance: Revenues and Expenditures in a Democratic Society.* Boston: Little, Brown Co., 1983.

THE POLITICAL PSYCHOLOGY OF ECONOMIC TRANSFERS

Mark Lilla

Economics is most enlightening (at least it is most enlightening to me, a backsliding economist) when it is rigorous psychology: it tells us most when it tells us how people actually feel and behave. We know from experience that, when the price of a good or activity rises, people consume less, and when it falls they consume more. We know intuitively that people prefer satisfaction now rather than later, and that marginal satisfaction declines as we consume more of something. We learn in introductory economics classes that these are just working assumptions we make about rational behavior, but actually they are psychological generalizations—and fairly good ones at that.

James Gwartney and Richard Stroup (1986) have compiled what seems to me an exhaustive catalog of how economic transfers can fail to achieve certain ends when these psychological facts are ignored. Life, they remind us, does not stop once the transfer is made: ordinary people and politicians adjust their behavior, and the results can be quite different from those originally intended. I cannot hope to add to this catalog, but I would like to ask some questions about the economic framework in which the authors have raised these issues, and what economics today can and cannot tell us about the "transfer society."

The psychological economic presuppositions I mentioned all refer to individuals and their behavior as individuals faced with choices and constraints. But economic transfers are established collectively and take place between different individuals. What, if any, psychological foundation is there for this activity as understood by economists?

Welfare economics, as taught and practiced in the profession today, provides one answer by looking at the distribution of taxes and

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Associate Editor of *The Public Interest* and a doctoral candidate in government at Harvard.

benefits generally, and at income distribution in particular. Initially, this examination of distributions is given a narrow analytic function. If anyone wishes to know who pays and who receives, how much is wasted in the process, and how equal those distributions are, welfare economics can provide the answer without committing itself to the value of that distribution. But we all know that economists do more than that. Whether on the political right or left, in the academy, government, or foundations, they also take these distributive questions to be *the* measure of the outcomes of public policy. They especially display their concern for what they take to be economic justice when they devote themselves to the study of the income distribution: every year we are informed how the top and bottom tails of the income distribution have changed, what role taxes and transfers played in that change, and what the distribution is for minorities, women, the aged, and so on. So this analytical effort tries to take on political force by presupposing that it reflects a psychological fact about human beings: that voters (but also public officials and opinion makers) care about the income distribution—or, more generally, the precise distribution of the costs and benefits associated with public programs.

Public officials and opinion makers probably do seem to care about these distributions as defined by the economics profession, if only because they once studied some economics. But the astonishing thing about the American people is that they do not care. Surveys conducted by social scientists—and there have been quite a few recently—all bear out this fundamental point. While Americans feel strongly about political equality, and they believe in open opportunity in economic matters, they are unconcerned about the current distribution of income. And, no matter what their class, they have no desire to make that distribution more equal. In fact, they do not even seem to perceive the annual income distribution as defined by the economics profession. When asked about their economic expectations, about justice and fairness, they will speak about the importance of equal opportunity, especially in education, but also about effort, mobility, tenacity, and keeping what you earn. And rather than speak about their individual income they will focus on their children and their children's future. This point is very important. Family, not the individual, is their "unit of analysis" in thinking about distributive matters; some far distant future, and not the present, is their time frame.

Social scientists are utterly baffled when they encounter these views. Why, they wonder, are Americans so inconsistent? Why do the poor and working classes not desire, or even speak of, a more equal income distribution? Why are they still attached to capitalism? The answer, of course, is that the political psychology of economic justice in America has nothing whatsoever to do with the economist's "income distribution." This does not mean that Americans do not care about economic justice; they simply think about it differently. The debate over economic justice takes place within a general American consensus about the political order within which economic relations take place, the nature of citizenship, the importance of family and individual responsibility, and the foundations of human dignity. So perhaps we can add one more item to the Gwartney and Stroup catalog of transfer problems: to economic failings we should add political failings that can occur when public policies explicitly try to change the income distribution—a concept that makes analytical sense but lacks psychological resonance with most Americans.

But if we wish to be politically and psychologically realistic about transfer programs, and leave behind the fiction of income redistribution, we must also try to explain why we have these programs. Just as the critics of American capitalism find the public "confused" about the income distribution, so the critics of transfer programs find the public "confused" about the welfare state. For example, public choice theory (if I may display my prejudices here) tries to show how politics produces an inefficient transfer system that no one really wanted in the first place. While this may be true for a number of special-interest subsidies, the American public nevertheless supports the big ticket items in the welfare state. Yes, these programs should not give money to the undeserving or dissuade people from working, but by and large they are seen to be good things.

Economists are a patient bunch, but when faced with indifference to "Pareto-optimal moves" they become testy. Why, they wonder, do public officials and voters not understand how wasteful our transfer system is, and that there are better ways to move cash from one pair of hands to another? The real answer, once again, is that Americans do not think of the welfare state as a transfer system that changes the distribution of income. The major programs—in health, social security, welfare, education, even rural electrification—were created for other reasons, in their view. They were meant to incorporate people into the political community, to protect them collectively against misfortune, and to express how we see ourselves as a nation. The welfare state, in their eyes, is more than a check-writing and check-cashing enterprise.

Of course, this does not mean that we cannot learn a great deal about public programs by analyzing them as if they were merely transfers, and asking how efficient and equitable they are. Economics will always play a role in our understanding of social programs, if only because the values and behavior that economics studies continue to have some psychological resonance with us. The role of economic analysis will depend on the program, however. New Yorkers, for example, would love to have cheaper cabs, and economists can perhaps play a role in helping them understand their problem—just as economists played a crucial role in airline deregulation. But economists' advice about the negative income tax has fallen on deaf ears for decades because their claim—that we can do the same thing for less money—is just not true. Americans do not think that a negative income tax covering everyone is the *same thing* as a number of narrow programs with specific targets, limited eligibility, and certain obligations. However much economics tells us about matters that concern us in public policy, its contribution has been limited by its psychological narrowness, and we must look beyond it—to history and politics—to give a complete picture of American capitalism and the welfare state today.

So my only dissent from the paper is that it does not seem to recognize the limits of its undoubtedly sound analysis. This shows up most interestingly in the discussion of 19th-century homesteading, which is analyzed as a transfer program. While such a thing is possible, I frankly cannot imagine any 19th-century Americans thinking about it in such terms. The nature of the program, they would say, is an expression of American expectations for the future, or spiritual self-discovery, or the building of Christian communities, or the democratic possibilities of the American economy. Understood in this way, their behavior is perfectly rational: they wanted to play a role in that larger project, even if they failed. They wanted to build communities for their children and grandchildren, even if that meant sacrificing the health and happiness of one generation. They gladly sought out the left-tail of the income distribution to achieve something higher, just as the Korean owners of New York's fruit stands are working around the clock in appalling conditions to give their kids a chance today.

Economists know that people behave this way, of course, and I would not be surprised if they do, too. The issue is whether this kind of behavior and the psychology it reflects can be incorporated into the economic analysis of bourgeois capitalism and democratic public policy. We might have to sacrifice the mathematical rigor that we have come to expect from economics, but I cannot help thinking that we would learn even more about the problems and possibilities of the "transfer society" than we know today.

Reference

Gwartney, James, and Stroup, Richard. "Transfers, Equality, and the Limits of Public Policy." *Cato Journal* 6 (Spring/Summer 1986): 111–37.

TRANSITIONAL GAINS AND TRANSFERS

Gordon Tullock

Information Costs and Transitional Gains from Oil

I recently visited Alaska, which had an unusual problem, a problem in fact that it shared only with such places as Saudi Arabia and the Trucial States. The problem was government revenue far above any conceivable direct government expenditures. In all three cases this revenue came from oil reserves, which were confiscated in the case of Saudi Arabia, and in the case of Alaska subjected to a high fee.

When Alaska began to consider this windfall, the state first decided simply to distribute it in cash to Alaskans. It then occurred to them that since any American has a perfect right to move to Alaska, the net effect would be a large in-migration. If the state had gone through with this procedure,[1] there would have been a period of time in which Alaskan natives were receiving large sums of money, and people would have been pouring into Alaska. As the people poured into Alaska the per capita payments would have gone down,[2] and the return from labor invested in productive activity in Alaska would have fallen sharply because the people who had moved in expecting this payment would be willing to supplement their income by working at very low wages.

At the same time, of course, the returns on rental real estate in Alaska would rise very sharply, and various industries that received this influx of cheap labor would probably become extremely profitable. Adjustment to all of this might take many years. Indeed, if

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Holbert R. Harris University Professor of Economics at the Center for the Study of Public Choice, George Mason University.

[1] I think the proposal was sensible, even if it would have the in-migration effect. Alaskans do, in fact, receive a small annual payment, but very much less than the value of the windfall.

[2] Of course, the deterioration of the cartel would have had the same effect.

people contemplating moving to Alaska thought that the cash payments would not continue indefinitely into the future, and hence discounted the prospect of the payments terminating against the quality of life in what is, after all, not the most pleasant of American states, it is likely that the original inhabitants would have a permanent net transfer to them, equivalent roughly to this risk premium plus the cost of moving for citizens of the lower forty-nine. Still, the really big gains would have been in the early days and would have been only transitional. In practice, and I shall return to this below, it was decided to use the money for purposes that on the whole were a good deal less valuable.

Saudi Arabia and other Arab participants in the oil cartel did not have this problem, since they are not required to permit noncitizens to immigrate. Various American Indian tribes[3] were likewise permitted under U.S. law to particularize the entire benefits of oil revenues to their own members. A given tribe that decided to enter into a contract with an oil company for the exploitation of its tribal area or that was compensated by either the U.S. government or the state of Alaska for land taken over could have simply distributed the money among its members. There does not seem to be any evidence that they even contemplated this particular simple and efficient solution.

I have an acquaintance who was an ambassador in Arab areas and who speaks excellent Arabic. He was discussing with me the economic situation in one of the minor Arab states and remarked that they had a revenue so large that there was no conceivable way of making use of it. Actually there are many ways, but the one I suggested to him was simply paying it out to the subjects of the sheikh.[4] It was clear that he had not previously thought about this, and certainly none of these governments seems to have contemplated it. The Alaskan government did give some thought to the matter, as mentioned, but decided against it.

It seems to me that direct payments out would have been a sensible thing to do, but because the profits of the oil would come as an income stream over time and this income stream in the future was of necessity rather uncertain, the distribution of a current property right to some particular share of future incomes would no doubt have been preferred by the citizens of Saudi Arabia or Alaska to the direct cash payment. Further, by making this distribution immediately, the prospect of in-migration to Alaska would have been sharply reduced.

---

[3] Sometimes called original Americans, although, as a matter of fact, they seem to have arrived after Folsom man, and to have killed him off.

[4] In practice, it was very largely paid out to the family of the sheikh.

Thus each Alaskan citizen could have been given a transferable certificate permitting its owner to receive one one-hundred and fifty-seventh thousandth, or whatever is the correct number of the future oil royalties received by the state of Alaska. In the case of the Arab countries, it would have been even simpler to incorporate the new nationalized oil companies and give shares to their citizens. Some arrangement to make certain that the cartel remained intact would of course be desirable. It seems likely that a private corporation owned by the citizens of the various Arab countries would have been a more efficient way of handling this problem than OPEC.

In all of these cases, it would have been possible to arrange so that the transitional gain made by the beneficiaries of these very large transfers was indeed the whole potential value of the OPEC cartel.[5] But that is not what happened. In fact, the gains received by the average citizen of Alaska, or the average member of an American Indian tribe in Alaska, are much lower than the potential profits. The same is true with respect to the Arab states, although in this case the ruling classes have done very well. Nevertheless, the amounts they have received are very much less than the present value of the cartel at the time it was organized. There have been immense wastes.

Further, it seems likely that in all of these areas, by now, no one is actually making any gains. The Arab prince is probably now making about the same return on his rights in Saudi Arabia as he is on his investments in South Carolina farm land, if we discount properly for the relative riskiness of these two investments. He received very large gains originally, and the bulk of these he has kept in the form of investments, whether in the form of bank accounts in Zurich or retaining his rights in Saudi Arabia which he could have unloaded, albeit, they were not subject to ordinary sale transactions. Disposing of them in return for further investments in, say, Portugal, would have involved a political rather than a purely commercial transaction. Nevertheless, it was possible.

Thus, very large potential gains were in fact sacrificed by the "owners" of these potential transfers. The reason seems to have been largely *information difficulties* that prevented them from realizing just how wealthy they were. They turned to expert advisors like my friend, the American ambassador. These expert advisors were, first, not very expert and, second, heavily biased toward spending the money in some way other than simply enriching the Arabs or the citizens of Alaska.

---

[5] The Alaskans would, of course, have made something out of their oil even without the organization of OPEC, but much less.

Winners and Losers under Alternative Transfer Schemes

In general, the experts developed systems under which the money would go to some kind of "development" in the area. In some cases, this "development" went into direct investments in nonoil resources, which at least in theory were going to be around after the oil was exhausted. My guess is that the investments are not very good, and hence the returns will not be great. There is, for example, a building in downtown Juneau that is the headquarters of the corporation of one of the Indian tribes. The corporation exists to invest the tribe's ill-gotten gains. I am sure the executives of the corporation will do reasonably well, but it is not obvious that anyone else will.[6]

This is characteristic of most of the redistribution methods that I have described. The "technical" personnel who are involved in advising and making use of the funds have normally obtained for themselves an increase in income. In the case of the Saudi Arabian example this increase in income has been very great indeed. In Alaska it is probably quite modest, with civil servants being paid more and there being more of them than there were before, but no giant gains.

Practically no one, when asked how this money should be spent, suggests simply distributing it to the citizenry. Another possibility, of course, would be distributing it only to the poor. Alaska does not have very many but there is no constitutional barrier preventing the state from distributing its money to poor people outside Alaska. One would think that the average left-wing intellectual would be in favor of such a distribution, but so far as I know, it has never been suggested. The end product of all of this is that most of the funds available from these particular large transfers were wasted, and many of the potential beneficiaries are probably not even aware that they are being mulcted.

Why is this money then used either to simply expand what we might call normal state activities or to cut taxes, and not directly paid to the citizenry? Clearly the citizens would be better off. Further, the king of Saudi Arabia would be better off if he had not decided that, in addition to paying off his family and various friends, he would undertake a fairly major development project in an area that is probably as resistant to development as any in the world. Clearly, if the development money had simply been paid out to the tribesmen, they would have done much better in terms of personal security and avoiding revolution than under the present arrangement. One would think that expenditures on secret police and armies also would be highly attractive, but only a small part of the oil revenue has been invested in such matters.

---

[6] Since writing the above, I have seen reports of the financial problems of the corporation. It just proves that social scientists can predict.

Note in particular that the expenditures in, say, Alaska for improving state services and reducing regular taxation are in general ultramarginal. That is, the services now provided would not be provided by the citizens if they had to pay for them in a more direct way. They were willing to pay only their previous tax rate for the previous services.[7] Thus, the money is being spent on things that are of less value than the money itself. Of course, the citizens now have a somewhat different income position than they had before, but in fact, the effect has been fairly minor granted the way the money is being spent.

The gains were transitional rather than permanent. If the expenditures have any benefit they will attract immigrants into Alaska to share in the gains, until such time as migration to Alaska and life in Seattle are equivalent. Of course cash would bring in many more people, but there is no obvious reason why the current citizens of Alaska would be deeply distressed by that. The state is so large that those who want privacy can easily find it even if the population goes up by several million.

If we consider the problem from the standpoint of the civil servants who are called on to advise, the transitional gains may be quite substantial. Their wages are raised, and as civil servants they can hardly be fired even if more civil servants are brought in at the new wage rate. Thus, bringing the whole matter into true equilibrium might take a full generation, and they would achieve transitional gains during that entire period.

If we consider the intellectuals who, generally speaking, tend to favor this kind of thing, it is hard to avoid the impression that they are simply making a mistake. That would not be true, of course, of intellectuals living in Chicago who would not gain from anything going on in Alaska. But one would think that newspaper reporters on Alaskan newspapers would prefer direct payment of cash to increases in the state services. It may be in this case, however, that the intellectual community was so small that they were completely dominated by intellectuals elsewhere. The intellectuals elsewhere would not I presume be terribly happy about direct payments to citizens of Alaska, whereas they might be strongly in favor of, say, government-sponsored housing there.

---

[7] Insofar as the voting process measures these two factors.

The latter explanation also might apply in Saudi Arabia, which had practically no intellectuals with any economic background. Intellectuals from the outside, like my friend the ambassador, would not have gained from any direct cash payment, and in the United States tend to be vaguely in favor of various government projects. They can transfer that vague preference to the Trucial States by way of bad advice at no cost to themselves.

So far, I have discussed this particular, very pleasant transfer entirely from the standpoint of the beneficiaries. It is notable that most of the losers did not seem to think there was anything much they could do about it. Further, they had a strong tendency to blame the wrong people.[8] That there were very real and very large effects on the victims is of course true, and it is also true that these effects were larger than the benefits that the recipients would have received if they had taken it in straightforward cash.

This is of course characteristic of most transfers by government. In this case, successful efforts on the part of the oil consumers in the United States to reduce the transitional cost of the organization of OPEC increased its total cost over time to those same consumers. Indeed, it is not positive that OPEC would have been able to remain in existence if the price control had not been slammed on retail gas expenditures at the beginning. Peculiar circumstances in which wealthy Texas oil men were compelled to subsidize the import of OPEC oil provided an additional market for the cartel, which may have been necessary for its stability.[9]

---

[8] In 1973, I spent some time in Pittsburgh and read the local Pittsburgh paper. Almost everyday, the paper had two leading stories. One story was invariably an account of OPEC meetings and OPEC ministers' decisions about prices, production, etc., and the other an attack on American oil companies for raising oil prices. The probable reason for this was not entirely muddle. The voters could do something nasty to the American oil companies without violating their own moral code. A naval expedition up the Persian Gulf, although a trivial military activity, would have appeared to them to be imperialistic and wicked and hence they were not going to think about it. For another account of somewhat the same phenomenon, see Olmstead and Rhode (1985).

[9] Public misunderstanding was extreme. Byers and Fitzpatrick (1986, p. 43) say, "Throughout the protracted energy problems of the 1970s, Americans doubted there was a real oil and gasoline shortage stemming from a genuine depletion of natural resources. They believed that the oil shortages were contrived—a conspiracy manufactured by large oil companies." Notably, Byers and Fitzpatrick also do not seem to be aware of OPEC's role. The long delay imposed by the environmental movement on the trans-Alaskan pipeline was almost certainly also important. If it had come into production at its originally planned capacity and date (1973), it is dubious that the Arabs would have even tried to organize the cartel. Possibly those environmental lawsuits were the most expensive that have ever been filed anywhere in the world.

But these are what we might call pleasant transfers. The beneficiaries of the transfers did not have to impose any cost on anyone who was politically relevant to them. They could simply take the money. In the case of Alaska, they were not called on to do anything that imposed costs on anyone. Selling their petroleum at the highest price was indeed the course of action that benefited the rest of the world more than any alternative.[10]

The Arabs organized a cartel, but it seems to have been an accidental by-product of the 1973 war. The strengthening of the cartel in 1979 was also a by-product, in this case of the Iran-Iraq war. In any event, the people injured by the cartel were entirely outside of the Arabs' direct political jurisdiction. Thus, it is quite different from the average cartel. Indeed, it closely resembles such things as the piratical expeditions of Drake.

Transitional Gains from Higher Education

Let us consider then some more normal transfers. The obvious one, of course, is the transfer of money from the average citizen to people who have more than average talent and hence would normally have higher then average incomes, by way of the university system. The first thing to be said here is that it is not really obvious that there is any true transfer here except for inframarginal individuals. Those of us who are inside the margin, either as employees of universities or as students, may be making a gain in the form of a rent, but as usual in economics, it is not very obvious that there are inframarginal individuals or that the gains are very great.

Leaving this possibility aside, employees of the university system are being compensated at their opportunity cost. It may be that many of them have relatively little talent to do anything else so that the mere existence of the university system pushes their total income up, but this once again is not obvious. In any event, I propose to ignore the employees for a while and concentrate on the theoretical beneficiaries, the students.

If we go back to the early days when these universities were first founded, there clearly was a transitional gain. The first state university in the United States was in South Carolina, and there can be no doubt that the students who went there in the first few years made a gain even though the subjects they studied would, we would think today, have had no commercial value. They came out knowing Latin and Greek, but also certified as upper class. At first, there were relatively few such people in South Carolina. Thus, there was considerable scarcity value in the degree. With time of course, and with more people entering the university until such time as the present discounted income stream of going to the university was the same as going to work, this gain vanished. At this later stage, the university cost the state money but conferred no benefit on students. Government agencies are hard to terminate, however, and those students who were in residence at any given time would have lost from the termination of the university.[11] In this case, and I think this is very nearly unique, there would have been a transitional gain, however, from discontinuing the university. If it had been stopped, those people who had already graduated would with time have begun to get positive gains on their degrees because the number of university graduates would decline. The gain would be a distant one, however, since death and retirement is a very slow process.

---

[10] The federal government's refusal to permit exploration for oil in most of Alaska or the export of the oil is another matter.

Every expansion of the university would create a somewhat similar transitional gain for students who had not previously been eligible. Further, changes in the university, such as teaching subjects with more immediate commercial value, would be a distinct advantage to the students who took these courses in the early days. When the modernized university, with its new business and accounting courses had been in existence for some time, once again, students would make their decisions in such a way that the marginal student had an income the same as that of what he would have had had he chosen not to go to school.

As far as I can see, that is indeed what the present statistical studies of return to education show. There have been times in which it seemed to be positive, mainly after large expansions of the university, and then periods in which it seemed to be negative, but I suspect the latter was purely transitional.

I have given very little discussion to the alternative theory of higher education, which is that it is simply a certification process rather than an educational process. That is, the possession of a degree indicates that you have a certain level of intelligence and willingness to work hard, rather than that you have learned certain things. This theory has always been disliked by academics because it implies that we really are not teaching people very much, and that the students who choose easy courses and forget what they have learned right after the exam may well be wiser than we.

---

[11] The university was stopped and then restarted after a number of years as a result of post-Civil War developments.

I am going to continue paying relatively little attention to the certification aspect of the school. Clearly, if that is what it does, then it does it in a very inefficient way, and very large resources could be saved by switching to a more efficient way of measuring intelligence and willingness to work. I shall also pay little attention to the possible rents of faculty members.

The outstanding characteristics of this very large activity is that, insofar as it subsidizes anybody, it subsidizes people who would do well in life anyway. It is not obvious, however, that any subsidy is derived. It may be pure waste, and there is certainly a large element of waste. The beneficiaries were mainly people who achieved a transitional gain when the organization was set up and the running costs were quite high.

Note that in all of these cases there is the excess burden that is normally discussed in connection with any tax or monopoly. There is also another excess burden because recipients of the funds also change their behavior. There is then the rent-seeking cost, the cost of arranging all of this by lobbying or whatever methods are used, and in some cases a rent-avoidance cost of people who are trying to avoid paying these rents. Lastly, there is the pure waste through the inefficiency with which the funds are in fact transferred. It is to this last cost that I now wish to turn.

The Rationale for Inefficient Transfers

Consider the current educational system and assume that the money raised from the taxpayer to pay for higher education was simply given as a cash gift to those people who have the capacities to get through whatever the requirements of the university are. They could then use this amount of money to pay tuition in a school that charged its full costs, which might be much lower than those that our present universities charge, or they could invest it in some other way. If you do not trust young people, you might insist that they invest it rather than spend it, although it is by no means obvious that time spent in the university is actually an investment rather than a consumption good.

Clearly, the excess burden to the taxpayer would be the same, but the excess burden on the recipients would be less than with our present arrangement. It is not obvious what would happen to the rent-seeking cost because this large sum of money would probably be worth more to the recipients, so they would be willing to invest more in rent seeking. Producers of things that the potential students would choose not to buy would suffer to some extent, although presumably not a great deal, and those who are providing things the students would choose to buy would gain. Again, probably not a great deal. Except for one group of factor producers, nobody seems to be injured by the change, but it should be said that the factor producers would be the ones to whom the legislature and the average citizen would normally turn for advice on reorganization of the educational system.

In Alaska somewhat the same situation pertains. Simply paying the money out in cash to the citizens of Alaska, preferably in the form of transferable certificates for future income, would be better from their standpoint and would injure no one except a certain number of factor producers, in this case primarily civil servants or potential civil servants. Again the loss would be small, and the gain to other factor producers would also be small. It is hard to see what the effect on rent-seeking activity would be in this case, because it would be very important that this be done quickly so that a large number of people would not pour into Alaska to share the gift.

Why do we not observe these efficient methods of transfer instead of the inefficient methods? I think the answer is ignorance. If we look at the learned literature, we find the only kinds of transfer that are ever advocated are transfers to the poor, a real but not very large part of our transfer economy. Most people are willing to make at least some gifts to the poor, and doing so is actually a productive activity that makes both the giver and the recipient better off.

Transfers back and forth in the middle class, however, which is what we actually observe, are discussed only by people who argue that they should stop. You can search the literature in great detail without finding anyone who actually is arguing for an efficient method of making them. People who talk about them invariably talk about them as undesirable.

There is an old chestnut which I heard when I was at the University of Chicago before World War II and which still is occasionally repeated by Chicago types. It is that we could make the farmers of the United States much better off than they are now while saving the taxpayer money by simply giving them cash instead of maintaining our present programs. This was not offered as a real suggestion, but as a criticism of our present programs.

Indeed, in this case, the statement about transfers is normally made in a very casual and careless way with the result that Gary Becker (1983) was able to demonstrate that it was not obviously correct. It might be quite difficult to distribute cash to the farmers in exactly the same amounts as they now receive. None of the people who offered this typically Chicagoan criticism ever gave any attention to it, and hence it is easy for Becker to demonstrate that their specific proposals would not distribute the money in exactly the same way as the present program.[12]

In all of this, the proposal is typical. We find in the literature occasional references to this kind of transfer, which is after all the dominant one in our society, as being inefficient in contrast to a cash transfer. We never find discussion of how *efficient* transfers from badly organized middle-class voters to well-organized groups should be organized.

Under the circumstances, it would not be surprising if the average voter or the average politician were ignorant of how to do it. I do not think that very many economists have given any thought to the matter. The reason that economists have not given any thought to this, and for that matter are not likely to, is first, it is obviously a bad thing to do. Second, politically no one is going to follow their advice because a certain element of concealment and confusion is necessary to get the voters to favor such programs. Open cash transfers, which appear to be the efficient way, are just too blatant and could not get through in a democracy.

Thus, we have a combination of an absence of any technical discussion of this subject in the technical literature, and strong reasons why people in favor of such transfers would not be willing to talk in clear-cut efficiency terms. Thus, that people would behave in a rather inefficient way is not at all surprising.

Another problem is that other groups who might conceivably offer technical advice in these areas—government employees and potential government employees who will eventually administer the programs—are, on the whole, not in favor of efficient transfers. Their salaries depend to a considerable extent on the existence of fairly large and complex structures which may be eliminated in the name of efficiency. The academics who are hired by these people to engage in research on these programs also normally know on which side their bread is buttered.

Further, the people who are professionally engaged in urging this kind of transfer normally are aware that simple efficient transfers would not get through the democratic process. Hence, one of their major talents is in inventing complicated procedures that conceal the nature of the transfer and which almost by definition are apt to be inefficient.

---

[12] There is no reason to believe that the politicians have selected the optimal redistribution money from the standpoint of political gain.

The result is inefficient transfers—transfers so inefficient that normally only the transitional gain is real. The transitional gain, of course, tends to be devoured by rent-seeking costs. The result is what I call the "Chinese type economy" and what my old friend Alex Kafka referred to as "South Americanization," in which government is engaged in a very large number of activities that are normally a sort of distant result of rent seeking sometime in the past. There is usually strong opposition by various well-organized special interests to terminating the program.

More efficient transfers could, of course, if we only go this far, lead to a higher national income. Unfortunately, these more efficient transfers would inevitably lead to more rent seeking. If there is more money to be obtained, more resources will be put into seeking it.

Conclusion

The general picture that emerges is not a very pleasant one. No one looking at real world governments can doubt that they do to some extent generate genuine public goods. No one observing them can doubt they also engage in a lot of transfers, mostly the result of rent seeking. Indeed, Dwight Lee (1986) has argued that what public goods they do generate are normally a by-product of rent seeking by the factor suppliers in those areas.

In the 19th century, England deliberately and consciously moved away from a very well-developed, rent-seeking society to one of the most open economies known to history. I can think of few more important research topics than a careful examination of how they did it. By this I do not mean what bills they passed, but how the political support was developed for those bills. Lacking the magic formula which might conceivably come out of that research, all we can do today is to argue against rent-seeking activity. Whether our arguments will have any impact is an open question.

References

Becker, Gary S. "A Theory of Competition Among Pressure Groups for Political Influence." *Quarterly Journal of Economics* 98 (August 1983): 371–400.

Byers, Edward, and Fitzpatrick, Thomas B. "Americans and the Oil Companies: Tentative Tolerance in a Time of Plenty." *Public Opinion* 8 (December/January 1986): 43–46.

Lee, Dwight R. "Public Goods and Politics: The Usefulness of Inefficiency." Working Paper, Department of Economics, University of Georgia, 1986.

Olmstead, A. L., and Rhode, P. "Rationing without Government." *American Economic Review* 75 (December 1985): 1044–55.

WEALTH TRANSFERS IN A RENT-SEEKING POLITY

Richard E. Wagner

Introduction

That the "War on Poverty" that commenced in the late 1960s would have retarded and perhaps even reversed the rate at which people advanced above some arbitrarily established poverty level would have been commonplace to nearly any economist from the late 18th century until the mid-20th century. It was clear to those economists that the receipt of transfers would reduce the efforts of recipients to earn income, and so would slow their economic advancement. It was equally clear to those economists that the payment of additional taxes to finance income transfers also would reduce the efforts of those with higher incomes, and this reduced effort further would dampen capital accumulation and economic progress. Arguments and evidence presented by such people as George Gilder and Charles Murray would have been eminently reasonable to classical economists, as Henry Fawcett's 1871 work shows.

At the same time, however, the enactment of such programs by legislatures despite, and perhaps even because of, their consequences is fully consistent with our knowledge of public choice processes. Because it is difficult to attribute the enactment of such programs to faulty economic understanding by legislators, even though there is always room for improved understanding, it would seem to follow that significant reform requires more than better analysis of the consequences of particular measures—and requires instead some type of institutional or constitutional reformation in the processes through which public choices emerge.

In this essay I explore some political and economic sources of the disparity between the rationalizations or justifications for the transfer

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at Florida State University.

programs of the so-called welfare state and what appears to be a quite different reality. In doing so, I focus on the insights provided by the contemporary literature on rent seeking and public choice. There is a growing body of literature that suggests that the policies that have brought about such consequences are actually natural outcomes of an institutional regime of unlimited or majoritarian democracy. This essay seeks, first, to describe and explain some aspects of the chasm separating the common justifications for the various programs of the welfare state from their actual consequences and, second, to set forth some of the resulting implications for constitutional reformation.

Justifying Wealth Transfers in a Liberal Democracy

Since people have developed numerous justifications for wealth transfers, it is first necessary to give a brief description of common approaches to these justifications. Moreover, within the basically liberal framework of the American political order, approaches to justification must be grounded in some argument about why people might agree to programs for wealth transfers. As compared with a protection-choked economy, a free economy allows people to achieve a higher average level of wealth. But a free economy also entails greater uncertainty about the future value of present investments in human and physical capital, because of the quickened pace of change it entails. The more open the economy is to competition, the quicker will be the flow of disruptions and new opportunities from such things as inventions, the introduction of new products, and changes in personal wants. The realized value of any investment in physical or human capital will be more fully open to future challenge in a free economy. The quicker the pace of change, the less likely are skills acquired in youth to be serviceable throughout one's lifetime. Certain enterprises may be left behind by new technologies, changing consumer preferences, or population relocations.

The generally progressive character of a market economy is a source of uncertainty against which people might plausibly like to insure. Consequently, some type of income insurance might be agreeable to all participants from an ex ante perspective, and would thereby serve as a rationale for some type of income-sharing program that would appear ex post to constitute a transfer program. There are several ways this idea might be expressed. Buchanan and Tullock (1962, pp. 189–99), for example, used such reasoning as a possible justification for progressive income taxation. Faced with uncertainty about future income prospects, people might prefer progressive over proportional income taxation because progressive taxation allows them to attain smoother time-paths of consumption than would otherwise be possible. If people are aptly characterized as having diminishing marginal utility of income, the ability to concentrate their tax payments in years when their income is relatively high will reduce the utility sacrificed through taxation, as compared with what it would be if the same amount of taxes were extracted at a proportional rate. Moreover, uncertainty about future income surely looms larger when future prospects are projected forward from youth than when they are seen from the perspective of middle age or the hindsight of old age. Therefore, the younger people are, the greater will be the scope for their reaching some agreement about the type of tax system they will live under.

Another justification, which was given a strong impetus by the work of Hochman and Rodgers (1969), treats the provision of charity as a public good, through the use of presumptions about utility interdependence. In that literature, income transfers are seen as voluntary transfers from donors to donees. State participation in the transfer of income, rather than exclusive reliance on private charity, is rationalized by the presumption that free-rider problems would plague private charity. Although people might like to act charitably, no one person acting alone could significantly improve the conditions of recipients without some guarantee that everyone would contribute, and so few or none would do so. Therefore, the use of government to transfer income is rationalized as a vehicle for overcoming the free-rider dilemma.

It is also possible to justify transfers as being necessary for the promotion of domestic tranquillity, a line of justification that is perhaps observationally equivalent to the preceding approaches to justification. Consider James Buchanan's (1976) Hobbesian reformulation of John Rawls's difference principle. Rawls advanced the normative argument that inequalities should be permitted only to the extent that they result in an improved position for the least well-off person in society. In Buchanan's formulation, however, something like the difference principle is necessary for domestic tranquillity. A minimal condition of social stability is surely a requirement that people receive higher returns by adhering to the rules of a particular social order than they could receive by violating those rules and reverting to some form of Hobbesian anarchy. Hence, the difference principle can be interpreted as a positive statement of one necessary condition for the stability of a particular institutional order, and so can provide a justification for some level of guaranteed income.

Dissonance Between Rationale and Reality?

To advance a rationalization for wealth transfers is not, however, equivalent to advancing an explanation for them, because there may be other, more satisfactory explanations of why such transfers are made. For instance, justifications grounded in analogies with income insurance would seem to have some obvious flaws. If insurance were purchased retrospectively, those who fared well would want no coverage, and those who fared poorly would want extensive coverage. Insurance is possible only because it is purchased prospectively. Tax institutions and transfer programs, on the other hand, are to a large degree chosen retrospectively. Compared with the choices they would have made prospectively, people with high incomes will desire reduced coverage, while people with low incomes will desire expanded coverage. In such a setting, there is good reason to expect excessive transfers to emerge from democratic processes of collective choice. So long as the modal income is below the mean income, a majority of people will have below-average incomes and can thus gain by choosing fuller insurance (that is, larger transfers) than they would have chosen under a prospective choice setting. Even though the social insurance justification might explain some aspects of the support for wealth transfers, those transfers are likely to be more extensive than is consistent with the justification.

Public charity justifications for wealth transfers encounter a similar dissonance when compared with actual processes for the production of wealth transfers. The public charity justification envisions an agreement among donors that allows them to escape the free-rider dilemma they would confront if charity were a purely private activity. Wealth transfers emerge from a collective choice among donors, and the resulting transfer budget will depend on both the extent of utility interdependence and the rules for making collective choices. Assume, for example, there are three donors and two recipients, with the donors preferring transfer budgets of $100, $200, and $300 respectively. If the donors choose a transfer budget by majority rule, a median voter model would yield a transfer budget of $200, or $100 per recipient. But when the recipients are able to vote on the size of the transfers they receive, the size of such transfers is likely to expand beyond the amount that would be consistent with the public charity justification. In this model recipients would surely prefer the $300 budget to the two smaller budgets. Thus the $300 budget would be the collective choice. Even though utility interdependence might explain some elements of the demand for wealth transfers, actual processes of collective choice are likely to produce excessive transfers as compared with the postulated normative standard; as Tullock (1981) argues, the interest of recipients in receiving transfers is surely the most substantial component in any explanation of wealth transfers.[1]

In like manner, the justification for wealth transfers as being the price of domestic tranquillity also confronts a disjuncture between the setting envisioned and the actual setting within which the pertinent choices regarding wealth transfers are made. It is surely reasonable to think that the sustainability of a particular social order depends on its participants believing they are better off living under its rules than they would be under some such alternative order as Hobbesian anarchy. However, in seeking to reconcile justification with reality, it is necessary to examine the processes through which such a determination would be made. Any such process would largely operate through complaints and protests. But once such activity comes to be rewarded, the amount of that activity will increase until the marginal return from the activity equals the marginal return from ordinary types of economic activity.

The question, of course, is how to distinguish legitimate grievances from tactics chosen to cajole someone else into giving up something. If complaints are automatically treated as legitimate and subsequently awarded some form of compensation, the volume of complaints will increase until the ability to compensate has been destroyed. Similarly, if complaints about an existing social order are automatically treated as legitimate and interpreted as evidence that people are being unjustly treated as compared with, say, Hobbesian anarchy, and if compensating payments are thereby made, the volume of such complaints will increase because complaining becomes a profitable activity. Parents, of course, encounter this problem regularly in dealing with children. Parents who reward complaining children will be run by their children. Sometimes, of course, children have legitimate grievances. And wise (and lucky) parents will be able to distinguish between the legitimate complaints and those that represent tactics for changing the distribution of wealth within the family. There is necessarily a tension between the two types of judgment, and it is easy to go too far in either direction. But, and for reasons to be considered more fully below, democratic governments are much more prone than parents to reward complaints, because governments bear a minuscule share in the resulting cost, whereas parents bear the entire cost.

---

[1] See Roberts (1984) for an examination of how, because of the political power of recipients, government transfers have crowded out private charity and have become excessive in comparison with the Paretian criterion on which the presumption of collective charity is based. See Pasour (1981) for a critical treatment of the public charity perspective.

Constitutional Regimes, Legislation, and Wealth Transfers

The collective choice processes by which wealth transfers actually arise differ in important respects from the processes that would be required to produce outcomes fully consistent with the justifications for those transfers. The literature on public choice has important implications for the conduct of wealth transfer programs and, indeed, for public policy in general. The production of public policy follows an economic logic: policy outcomes are a product of the interaction of people pursuing various and diverse interests, and with that interaction shaped by the opportunities offered and limitations imposed by a particular institutional-constitutional order.

Policy outcomes are seldom the result of inadequate knowledge and unforeseeable events impinging on good intentions, and are more often the understandable working out of people's pursuit of their interests within the incentives presented by a particular institutional order. Consequently, so-called policy failures are rarely failures from the point of view of those people who control the policy process. In this regard George Stigler's (1975) summary dictum is particularly apt: "The announced goals of a policy are sometimes unrelated or perversely related to its actual effects, and the *truly intended effects should be deduced from the actual effects*" (p. 140, emphasis in original).

It is conventional to view the transfer programs of the welfare state, as well as other government programs, in a partial equilibrium context, in that one policy market is examined in isolation from other policy markets. Hence, the programs of the welfare state are regarded as reflections of charitable interests, while other government programs reflect the operation of narrower versions of self-interest. It is well recognized that many conclusions from partial equilibrium analysis are negated or even reversed when analyzed from a general equilibrium perspective. I would similarly suggest that we take a general equilibrium perspective on the collective choice of policy measures. All programs and policies are produced by the same legislative institutions operating under the same constitutional rules. The mix of legislation that maximizes the value to a controlling set of politicians will be adjusted to equalize support at the margin from different programs. Tullock (1971) is surely correct in observing that, while people may be charitable, they are not charitable very much.

His observation, in conjunction with a general equilibrium perspective on legislation, suggests that the welfare state does not reflect the operation of our charitable side, while we become our normal, more selfish selves in regard to such other governmental activities as military spending, highway construction, and safety regulation.

The central characteristics of contemporary public policy in general, and that subset that is called the welfare state, are natural and inescapable consequences of a system of unconstrained, majoritarian democracy. Under such a system, legislative majorities are essentially unconstrained in making rules for others, as against being constrained to operate by the same rules as the other persons and organizations in society.[2] A system of unlimited or majoritarian democracy produces a variety of wealth transfers, some of which constitute the subset of programs called the welfare state; the programs that constitute the welfare state arise out of a particular political system, through the operation of the incentives contained within that system.

It is misleading to assess the welfare state without considering whatever else is produced by that system, and so it is inappropriate to assess transfer programs by looking only at that subset of programs commonly referred to as the welfare state. Those programs are not produced in isolation, but are part of a process that produces all the other programs as well. The outcomes that constitute the welfare state are simply nonseparable components of policy outcomes in general: the reduction in labor force participation and the increase in teenage pregnancies are produced by the same forces that produce $400 toilet seats for the military and fill caves in Missouri with cheese and milk—all are products of the incentives contained within a system of unlimited or rent-seeking democracy.

Rent seeking explains how a variety of regulations and market restrictions become natural outcomes of our prevailing political order.[3] These restrictions arise as part of a process in which legislation is sold to highest bidders; the rules by which this is done give strong survival value to outcomes that diminish the average level of wealth as a by-product of transferring wealth to the subset of people favored by that legislation. The outcome is a protection-riddled economy. Yet we must not forget that a protection-riddled economy is also an encumbrance-bound economy.

---

[2] See, for example, Norton (1985) on the development of this theme with respect to taxation.

[3] Tullock (1967) is the seminal work. For a selection of papers on rent seeking, see James Buchanan, Robert Tollison, and Gordon Tullock. See Tollison (1981) for a survey of scholarship on rent seeking.

Shelters and Encumbrances in a Rent-Seeking State

The course of public policy over the past half-century has been to restrict liberty by awarding entitlements and foreclosing options. Restrictions on liberty are consistent with the awarding of entitlements. One cannot protect unionized garment workers from lower-priced competition without also preventing people from making garments at home for resale, or preventing consumers from trying to find the best buys. One cannot award food and shelter to some people without forcing others to labor to provide that food and shelter. And one cannot improve another's returns to carpentry by restricting avenues of competition without, at the same time, preventing others from improving their situations through the practice of carpentry. One person's sheltered position is necessarily someone else's obstacle to improvement.

Consider, for example, restrictions on working at home. One case that has received attention recently concerns a 1943 regulation forbidding people to work at home in seven types of garment manufacture: knitted outerwear, women's garments, embroidery, handkerchief manufacturing, jewelry manufacturing, button and buckle manufacturing, and gloves and mittens.[4] Promulgation of this regulation was based on the Fair Labor Standards Act of 1938, which authorized the establishment of minimum wages. The ability to work at home is, of course, particularly beneficial to women with young children and people with physical handicaps. Mothers can care for their children at home while they work, and the physically handicapped can reduce the high costs of transportation to and from a job. Yet women with young children and the physically handicapped are among those for whom the welfare state is generally rationalized as seeking to help. The ban against homework is surely as much a product of rent-seeking legislation as is any transfer program of the welfare state.

The major beneficiaries from such restrictions are the members of labor unions and the producers of high-priced items who would be in competition with people who work at home. By preventing such manufacture at home, the supply of lower-priced alternatives to garments manufactured in factories is reduced. This increases the demand for factory-produced garments. To the extent the supply of labor to the manufacture of garments is less than perfectly elastic, the prohibition of homework will increase wage rates in unionized factories. This program is equivalent to placing a tax on homeworkers and using the revenues to subsidize factory workers.

---

[4] See Germanis (1984) for a discussion of the prohibition against working at home.

It is well documented that minimum wage legislation reduces employment opportunities and contributes to the maintenance of low incomes. By raising the cost of labor, minimum wage requirements reduce the number of people that employers will hire. Most low-wage jobs are entry-level positions, and there would be many more such jobs if they were not foreclosed by minimum wage legislation. Further, if entry-level jobs are foreclosed, the opportunity for learning skills necessary to move on to higher-paying jobs is also foreclosed. Work experiences contribute to a person's human capital, and thereby increase earnings potential. Without the experience afforded by entry-level employment that would pay less than the minimum wage, human capital accumulates at a lower rate, which in turn means that people are consigned to a lifetime of earning less than they would otherwise have been able to earn.

Minimum wage legislation is a good illustration of the wealth-transfer outcomes of majoritarian democracy and the dissonance between the justifications for the welfare state and the reality of what it actually accomplishes. Moreover, it is impossible to attribute such outcomes to ignorance; they must be attributed to intent. The effects of minimum wage legislation in aiding some people and harming others fit sensibly within the emerging economic theory of legislation. A welfare state that discourages work and capital accumulation, and encourages instead the reliance on transfer payments for support, would seem to be complementary to rent-seeking legislation that also tries to maintain the value of particular investments in human and physical capital by curtailing competition. Any creation of an entitlement or sheltered status concomitantly entails a limitation on the ability of someone else to earn a livelihood. The position of high-cost garment manufacturers is sheltered by preventing people from manufacturing garments in their homes for subsequent sale, and the ability of the latter to earn a livelihood, in this case by sewing, is impaired.

Such restrictive legislation fits comfortably within the theory of a rent-seeking polity when applied in a general equilibrium setting. Furthermore, such legislation has certain insurance-like properties. Rent-seeking legislation creates sheltered, protected status positions for some people but imposes disabilities on others, because those excluded from the sheltered position have fewer options. If legislation is to increase the payments that some people receive for their services, it must be through activities that restrict entry and/or establish minimum prices. But the better such shelters work, the greater the disability to others. To some extent the payments of the welfare state might be thought of as disability payments that are a nonseparable aspect of the rent-generating activities of a constitutional order of majoritarian democracy.

Status v. Opportunity in the Social Provision of Security

Despite the explosion in transfer spending over the past two decades, or perhaps because of it, the number of people whose money income would place them below the poverty line has generally increased (Gwartney and McCaleb 1985). Throughout the postwar period, poverty was declining due to general economic growth. But since 1968 the overall rate of poverty has increased about 20 percent. Although it is commonly presumed that the activities of the welfare state represent efforts to alleviate conditions that are presumed to accompany a free economy, there are strong grounds for believing that the activities themselves are actually a means of creating those very conditions. This possibility is made more plausible by the recognition that foreclosed opportunities are an inescapable component of a state that has the ability to award entitlements. In this case the welfare state would serve largely as a substitute for income that could have been earned, rather than as a provider of income that could not have been earned. Poverty would not so much be a "natural" feature of a free economy as it would be a product of the restricted, neomercantilist economy, of which the welfare state is one component.

People clearly have substantial interest in providing some measure of security for their future. One way that people can reduce the uncertainty they face is by trying to gain control of such sources of uncertainty as might arise from the actions of competitors in introducing new products, new techniques of production, new approaches to business conduct, and the like (Wiseman 1953). The creation of sheltered or protected wealth positions and the awarding of entitlements or transfers are complementary facets of the existing welfare state. The welfare state, as one manifestation of a rent-seeking polity, operates within the market for legislation by awarding subsidies and entitlements and by imposing taxes and limiting options. The state is involved in the extension of principles of status rather than the expansion of principles of contract and opportunity. The status-extending welfare state operates by trying to prevent the erosion of wealth positions by retarding the operation of forces for change within society.

There are understandable reasons why, in a system of majoritarian democracy, a status-oriented approach dominates an opportunity-oriented approach. In addition to rent seeking and the market for legislation, there is also the fact that democratic political processes are characterized by shorter, electorally truncated time horizons. The creation of status positions through shelters and entitlements confers an immediate gain to recipients, while the costs are vague and to a large extent reside in the future. When status positions are viewed from a short-run perspective, the programs of the welfare state seem primarily to concern the distribution of income and wealth. Proposals to expand transfer spending appear centrally to revolve around questions of whether some people should be taxed more heavily so that others can receive more benefits. But when they are viewed from a long-term perspective, those programs, and possible alternatives to them, primarily concern the creation and destruction of wealth. However, in light of the absence of a political equivalent to a capital market as a means of rendering a present evaluation of choices with future consequences, the political impact of wealth destruction would be weaker than its magnitude would seem to warrant.

The conflict between an emphasis on status and an emphasis on opportunity can be illustrated by James Buchanan's (1975) formulation of the "Samaritan's Dilemma." In the original story the Samaritan aided a man who had been robbed and beaten by thieves. Although that story described a unique event to which the Samaritan responded, the Samaritan's dilemma arises once the conduct of the Samaritan is generalized as a rule of conduct for all such situations. As the principle behind the Samaritan's choice is expanded from that of offering aid to beaten travelers between Jerusalem and Jericho to that of offering aid to people in a variety of circumstances that are regarded as misfortunate, supply elasticities are likely to increase. In the context of the welfare state, the Samaritans become those who wish to aid others they regard as relatively disadvantaged. The recipients of aid become analogous to the beaten traveler.

The nature of the Samaritan's dilemma is starkly simple. Once recipients recognize that the amount of the donation they receive varies inversely with the amount they earn on their own, they will have an incentive to reduce their own earnings so as to elicit larger contributions from the Samaritans. This is a relatively inferior outcome for the Samaritans, who want to supplement but not replace the recipients' efforts to care for themselves. The only way the Samaritans can get the recipients to increase their own earnings is by withholding aid, which threatens the Samaritans with an even less satisfactory outcome.

Status, Opportunity, Rent Seeking, and Race

Perhaps one of the best illustrations of the Samaritan's dilemma, and of the conflict between status and opportunity, is the racial aspect of the welfare state. This conflict appears regularly, for instance, in the contradictory assertion of being an "equal opportunity/affirmative action" employer. One can be an "affirmative action" employer or an "equal opportunity" employer, but not both. Affirmative action programs give preferential treatment to favored groups and thereby represent the extension of status relationships. Employees are hired, retained, and promoted on the basis of minority status and not on the basis of performance vis-à-vis other competitors. A policy of equal opportunity, by contrast, dictates that everyone be treated according to the same criteria, and represents the elevation of opportunity over status. Status is represented by the affirmative action award of privileged positions and is therefore a further manifestation of rent seeking. In contrast, equal opportunity means that restrictions on the ability of people to employ their talents are abolished and as such represent a restriction of the scope for rent seeking.

Although free competition tends to eliminate general racial differences in income and wealth, one can ask whether a regime grounded in opportunity or one grounded in status offers the shorter transition from the large racial income differentials to the absence of differentials that would eventually characterize a freely competitive economy. There are several economic reasons why the granting of a favored status, which might appear to be a means of speeding reduction of income differentials along more quickly, actually retards accomplishment of that goal. Suppose, for example, several newcomers join a running club. None of them is in particularly good shape, and initially they finish far behind the other members of the club. What is of concern is whether affirmative action (the extension of rent seeking) or equal opportunity (the curtailment of rent seeking) is the better approach to getting the newcomers to become competitive with the old-timers. The old-timers might, for instance, want to impose restrictions on the ability of the newcomers to train on weekends and evenings or for more than 40 hours per week. The equal opportunity approach would allow the newcomers to train as hard as they choose, free of restrictions imposed by the other members. The affirmative action approach, in contrast, would establish a set of handicaps and head starts. In a five-mile run, for instance, the newcomers could be given a one-mile head start and the old-timers could have four-pound lead weights strapped to their ankles. And the lengths of the head starts and weights of the lead anklets could be readjusted until the desired composition of newcomers and old-timers in the various finishing brackets had been attained.

Alternatively, suppose some of the newcomers lived under equal opportunity rules while the others lived under affirmative action rules. Under which set of rules would the newcomers more quickly become competitive with the old-timers? Which set of rules is more consistent with the fuller and quicker development of people's talents? Economic principles suggest clearly that it would be the equal opportunity regime; but at the same time public choice principles warn of the prevailing biases toward rent-seeking regimes. As compared with the equal opportunity regime, the affirmative action regime diminishes the incentives of the newcomers to become competitive quickly, because it becomes possible for them to win races without expending as much effort on training.

An additional problem arises once we recognize that the newcomers will differ in their own interests and abilities. In the equal opportunity regime, those who are best suited for racing because they have the ability and the interest will train hard and catch up with the others. But those who are weak on talent or interest will probably tire of finishing in the rear and will switch to some other activity. But the affirmative action regime diminishes the ability of such self-selection to reveal comparative advantages. If those with lesser interest or talent among the newcomers are given longer head starts than the other newcomers, self-selection processes will not work as strongly to ensure that those newcomers who are best suited to racing will be those who engage in it. Therefore, not only does affirmative action reduce performance levels, but it also reduces the extent to which the assignment of people to activities reflects comparative advantage.

Moreover, the rent-seeking regime of affirmative action might have long-run consequences that threaten to undermine it, at least with respect to race, though perhaps not with respect to other forms of rent seeking. Receiving a sheltered position is wealth-enhancing for the recipient. But it also reduces the luster of winning, because having defeated a lead-footed racer is surely less satisfying than defeating an unencumbered racer. In most cases this diminished luster is probably unimportant; I doubt if there are beauticians who feel haunted by the thought that there are others who could have done better than they, but were precluded by their weaker ability to pass exams on the histology of the hair, skin, and nails.

The negative side-effects of preferential treatment may be more pronounced with racial matters, however, where the issue is not one particular occupation among many but the very basis for first-class citizenship. Being excluded by someone else's sheltered status is perhaps a more sensitive issue in racial matters than in ordinary economic matters. Whereas many individuals are unaware of the extra money they pay for butter or sugar as a result of special privileges granted those producers, there is more general awareness of the problems represented by the Bakke case, and various related instances.

Conclusion

My purpose has been to examine some insights that the theory of public choice can bring to bear on some of the primary characteristics of wealth transfers and the welfare state. It has not been to advance or to discuss particular suggestions for reform. As for such reforms, it should be clear that I think both reason and evidence support the case for rejecting our neomercantilist economy, of which the welfare state is one inescapable component, and moving toward a free economy guided by principles of property and contract rather than by principles of entitlement and status.

If the welfare system or welfare state is viewed in isolation from other policy outcomes, it is relatively easy to articulate the types of reforms that would help soften the clash between the welfare state and the common welfare. Security can be provided only through capital accumulation within a well-integrated capital structure. However, the welfare state, in its status-extending manifestation, acts in contradictory fashion by awarding entitlements, conferring sheltered wealth positions, and generally attenuating and otherwise abridging ownership rights. In consequence, people are discouraged from working, saving, and accumulating capital, and are encouraged to be less responsible for the conduct of their lives. A welfare state that is consistent with the provision of security cannot rest on a foundation of taxing and transferring capital. Such a foundation undermines the requisites for genuine security on the part of all participants. Those who are taxed are discouraged from working and saving, and so too are those who are subsidized for not working and not saving. Genuine security requires creation of the opposing type of incentives: working, saving, and accumulating capital must be encouraged and not discouraged.

But neither my purpose nor my main interest and competence lie in the practicalities of welfare reform. What is raised most pertinently by the public choice perspective are some questions about possibilities for reform that go beyond the technical merits of various proposals. The central message of this perspective is that the actual operation of those institutions we call the welfare state will depend on the pattern of costs and gains that exist for different courses of conduct. What gets produced is what rewards the producers the most—in politics, in the transfer programs of the welfare state, and in economic life generally.

However, an opportunity-oriented welfare state would run afoul of the incentives of legislators within a rent-seeking polity. The status-extending welfare state is a natural component of a system of majoritarian, rent-seeking democracy. A legislature that simply awarded various sheltered positions by imposing restrictions on the ability of people to employ their talents would create a caste system, with those left outside being unable to provide for themselves. The award of support for not working and not saving is a natural accompaniment to policies that, for example, prohibit people from working for less than $3.35 per hour or in their homes, prohibit them from using their vehicles for transporting passengers or freight, and prohibit them from pruning trees, selling home-baked bread, or installing sprinkling systems for lawns. Such programs make it ever more difficult for people to support themselves as a by-product of the conferral of protected statuses on others. To some extent, then, the welfare state serves to mollify the social unrest that might otherwise erupt. Aggregate wealth is reduced, and more of a castelike society is created as income mobility lessens.

Although it is possible to articulate a general principle about the nature of a contract-extending welfare state whose modus operandi would be congruent with the underlying conditions for security within a society, welfare reform of the contract-extending type seems generally inconsistent with the system of incentives contained within our existing institutional-constitutional order. Our political system has become one in which government is a maker of rules for others, rather than being an adherent to the same rules as others. Since government is then able to make the rules to which others must adhere, a "market" will naturally arise to secure favorable rules and favorable interpretations of those rules. Consequently, the problems associated with the welfare state and its reform should not be viewed in isolation from all other political outcomes, but rather as a subset of a general pattern produced within a system of unlimited, majoritarian democracy.

This is not to deny that some deregulation of welfare could be achieved through ordinary political processes. But any such deregulation would be precarious in the absence of constitutional reformation. It is, of course, inconsistent with the theory of rent seeking to explain deregulation as the outcome of economists providing better knowledge; such an explanation is a public interest explanation of politics in conjunction with the ignorance that economists struggle to reduce. Deregulation is also attainable in a rent-seeking polity. What is required is that the value of opposing policy measures be equal to different sets of people, and with those people facing equal costs of political organization. But this makes deregulation, or the absence of regulation, or still more generally the maintenance of a free economy, a matter of the accidental constellation of political forces and not a central default setting of a constitutional order. To achieve this latter position requires constitutional reformation.

Once it is recognized that policy outcomes are primarily a result of the interplay of people pursuing their interests within a particular institutional or constitutional regime, it becomes difficult to attribute to error or ignorance the disparities between the goals that rhetoric sets for particular policies and the often quite different reality of what those policies actually accomplish. Rather, policy outcomes must be regarded largely as a natural outcome of the pattern of costs and rewards contained within any particular institutional or constitutional regime. The transfer programs of the welfare state are chosen as just one subset of outcomes of a political process, and it is unlikely that those programs will diverge greatly from the essential characteristics of political outcomes in general. As Anderson and Hill (1980) have documented for the United States, political institutions that increasingly reward rent-seeking activities relative to genuinely productive activities weaken the prospects that those same political processes will generate a welfare state that operates in contrary fashion. Those interested in promoting welfare reform should recognize that the concerns they address arise out of an institutional order in which the outcomes to which they are responding have positive survival value. Therefore, any effort to narrow the gap between justification and reality requires some change in the incentives within which the market for public policy operates—that is, political reformation—and not just more and better studies of the consequences of different policy options.

References

Anderson, Terry L., and Hill, Peter J. *The Birth of a Transfer Society*. Stanford, Calif.: Hoover Institution Press, 1980.

Buchanan, James M. "A Hobbesian Interpretation of the Rawlsian Difference Principle." *Kyklos* 29, no. 1 (1976): 5–25.

Buchanan, James M. "The Samaritan's Dilemma." In *Altruism, Morality, and Economic Theory*, pp. 71–85. Edited by Edmund Phelps. New York: Russell Sage, 1975.

Buchanan, James M., Tollison, Robert D., and Tullock, Gordon. *Toward a Theory of the Rent Seeking Society*. College Station: Texas A&M University Press, 1980.

Buchanan, James M., and Tullock, Gordon. *The Calculus of Consent*. Ann Arbor: University of Michigan Press, 1962.

Fawcett, Henry. *Pauperism: Its Causes and Remedies.* London: Macmillan, 1871.

Germanis, Peter. "Why Not Let Americans Work at Home?" Heritage Foundation *Backgrounder No.* 325. Washington, D.C.: Heritage Foundation, 1984.

Gilder, George. *Wealth and Poverty.* New York: Basic Books, 1981.

Gwartney, James, and McCaleb, Thomas S. "Have Antipoverty Programs Increased Poverty?" *Cato Journal* 5 (Spring 1985): 1–16.

Hochman, Harold M., and Rodgers, James D. "Pareto Optimal Redistribution." *American Economic Review* 59 (September 1969): 542–57.

Murray, Charles. *Losing Ground.* New York: Basic Books, 1984.

Norton, Gale Ann. "The Limitless Federal Taxing Power." *Harvard Journal of Law and Public Policy* 8, no. 3 (1985): 591–625.

Pasour, E. C., Jr. "Pareto Optimality as a Guide to Income Redistribution." *Public Choice* 36, no. 1 (1981): 75–87.

Rawls, John. *A Theory of Justice.* Cambridge: Harvard University Press, 1975.

Roberts, Russell D. "A Positive Model of Private Charity and Public Transfers." *Journal of Political Economy* 92 (February 1984): 136–48.

Stigler, George. *The Citizen and the State.* Chicago: University of Chicago Press, 1975.

Tollison, Robert D. "Rent Seeking: A Survey." *Kyklos* 35, no. 4 (1981): 575–602.

Tullock, Gordon. "The Welfare Costs of Tariffs, Monopolies, and Theft." *Economic Inquiry* 5 (June 1967): 224–32.

Tullock, Gordon. "The Charity of the Uncharitable." *Economic Inquiry* 9 (December 1971): 379–92.

Tullock, Gordon. "The Rhetoric and Reality of Redistribution." *Southern Economic Journal* 47 (April 1981): 895–907.

Wiseman, Jack. "Uncertainty, Costs, and Collectivist Economic Planning." *Economica* 20 (May 1953): 118–28.

ECONOMIC RENTS AS A BARRIER TO DEREGULATION

Robert W. Crandall

Rent seeking has been part of government regulation since at least 1887, when the railroads succeeded in gaining partial government enforcement of their cartels (Hilton 1966; Kolko 1965). Recent theories of regulation (Stigler 1971; Peltzman 1976) focus on this rent-seeking or wealth-transferring aspect of government regulation but are not particularly helpful in predicting when and where new regulatory initiatives will succeed. Nor do they necessarily predict when and where deregulation will succeed.

The past two decades have seen a remarkable combination of regulation and deregulation. During this period, the federal government has assumed wide responsibility for regulating occupational safety, product safety, and environmental discharges. At the same time, regulation has been sharply reduced or abandoned in trucking, airlines, banking, crude oil, natural gas, and cable television, and the courts have forced a major upheaval in telephone regulation. How can these diverse trends be explained by any theory of wealth transfer or rent seeking?

In this paper I argue that the wealth transfer theory also helps to explain the areas where legislated deregulation will occur. Once Congress effects wealth redistribution—whether intended or not—through regulation, it finds it very difficult to reverse course. I argue that this is not only true for long-standing programs of economic regulation but also for the newer health-safety-environmental regulation, where rent seeking is as prevalent as in the older regulatory programs.

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Senior Fellow in Economic Studies at the Brookings Institution.

Economic Deregulation—The Limited Role of Congress

The recent wave of economic deregulation has been remarkable from several perspectives. As late as 1975 it would have been difficult to predict that Congress would deregulate trucking, airlines, and (partially) railroads, and that even oil, natural gas, depository institutions, and cable television would be subject to a substantial modicum of deregulation.

The traditional Stigler-Peltzman theory of wealth transfer would seem to apply to regulation in these industries. Regulators have cartelized the suppliers who otherwise would face the discipline of market competition. Why, then, in the late 1970s, did the diffuse victims of regulation apparently rise up and inflict mortal political wounds on the more concentrated beneficiaries of these policies?

I doubt that we have a clear solution to this puzzle. Breyer (1982, pp. 191ff.) argues that legislated deregulation occurred when public-spirited congressmen and staffs publicized the "mismatch" between regulation and the public interest. Derthick and Quirk (1985, chap. 2) are largely in agreement, for they stress the role of economists and the economic literature in promoting deregulation. One does not have to be a cynic, however, to question the thesis that it was the persuasive testimony of regulatory economists that moved Congress to reverse course so suddenly in the 1970s.

Obviously, the inflationary pressures of the time helped. The Ford and Carter administrations inherited the inflationary problems created by OPEC, and both administrations sought single-shot assaults on the price level to slow the pace of inflation. Regulation provided some convenient targets.[1] There were proposals to deregulate trucking, airlines, cable television, and natural gas. The deregulatory legislative proposals that actually passed, however, were only those involving trucking and airlines, although some progress was made in natural gas, railroads, and, later, depository institutions.[2] Nevertheless, Congress has been unable to pass deregulatory legislation for telephone service, television broadcasting, old natural gas, insurance, or the merchant marine, despite equally compelling cases for action in these areas. Regulation in many of these latter markets, of course, has probably produced greater welfare losses than Interstate Commerce Commission (ICC) regulation of trucking or Civil Aeronautics Board (CAB) regulation of the airlines.

---

[1] Both administrations established regulatory reform groups to advance deregulation proposals, and both used the Council on Wage and Price Stability to induce regulators to be more aware of their effects on economic welfare.

[2] President Ford proposed deregulation of airlines and trucks, but both were passed in the Carter administration. In 1978 the Natural Gas Policy Act was passed, loosening the government's grip on new natural gas but keeping controls on "old" gas. In 1980 Congress passed the Depository Institutions Deregulation and Monetary Control Act, expanding the asset powers to thrift institutions, extending NOW accounts to all depository institutions, and phasing out interest-rate ceilings over a six-year period.

There has been little discussion of deregulation of television broadcasting (see Noll, Peck, and McGowan 1973; Besen et al. 1984), even though the market concentration in the television industry is the result of a decision by the Federal Communications Commission (FCC) to limit spectrum allocations. Obviously, the licensees have reaped enormous benefits from this contrived scarcity. The ratio of capitalized rents to the reproduction cost of assets in television broadcasting is higher than in any other federally regulated industry.[3]

Nor has Congress entertained proposals to eliminate its cartelization of the merchant marine. In fact, it has recently acted to strengthen this government-created cartel.[4]

The obstacle to deregulation of "old" natural gas is to be found in another form of wealth transfer, inadvertent as it might have been. It is doubtful that Congress could have known it would confer extremely large rents on purchasers of regulated, old natural gas when it passed the Natural Gas Act. Given the unequal geographical distribution of old and new gas consumption and that most of the old gas is supplied by the large oil companies while the high-priced new gas is more likely to be supplied by small independents, Congress has been unable to move toward deregulation of old gas. Their inaction defies persuasive evidence that such regulation distorts the allocation of energy supplies and reduces the development of natural gas reserves.[5] There are simply too many consumers, pipeline companies, and independent gas suppliers who would lose from such deregulation.[6]

---

[3] Crandall (1978). The capitalized value of the rents is estimated to be more than the reproduction costs of television industry assets.

[4] See Jantscher (1972) for an analysis of maritime regulation; see General Accounting Office (1982a) for a more recent measured critique.

[5] See Broadman (1985) for a review of current problems created by natural gas regulation; see Breyer and MacAvoy (1974) for an earlier analysis of natural gas regulation.

[6] It is far from clear that the regulation of "old" gas has transferred wealth from producers to consumers. The pipelines may have captured much of the rents, rather than the consumer (see the testimony of William A. Niskanen in Docket No. RM85-1-000, Federal Energy Regulatory Commission, 18 November 1985). If deregulation would benefit the large oil companies that have a large share of the old gas, while hurting many of the smaller independents that supply much of the high-cost new gas, it is not surprising that deregulation of old gas proved politically unpopular.

Nor is it likely that Congress could have predicted that federal-state regulators of telephone service would allow long-distance rates to be raised far above the cost of service in order to subsidize local service.[7] Nevertheless, there are now very large rent transfers between urban and rural telephone subscribers and between frequent and infrequent users of long-distance service. Legislative proposals to end these major pricing distortions through partial deregulation inevitably include the creation of a fund to bribe some of the losers. Even with provisions for such a fund, however, Congress has been unable to pass any significant amendments to the 1934 Communications Act.

In summary, it is misleading to think of deregulation as a sea change in representative democracy in which the victims rose up to deal the government-cartelized sellers a series of legislative defeats. More often than not, Congress failed to pass deregulatory statutes or even to consider them. Too many markets are still regulated—despite the welfare losses that such regulation undoubtedly creates—for one to believe that the political economy of regulation changed overnight in the 1970s. Much of the deregulation that actually occurred was, as we shall see, hardly the result of a social consensus that regulation was reducing economic welfare.

Deregulation by Legislation

Remarkably, legislative deregulation has been narrowly confined to transportation industries (and to the reversal of crude-oil regulation that developed at the time of OPEC-I). Thus, there is not all that much to explain if one wants to ask why Congress chose to enact deregulatory statutes in the past decade.

The two industries that were extensively deregulated by legislative action, trucking and airlines, did not benefit very much from regulatory cartelization. Airlines were not earning large regulation-induced monopoly rents before 1978 (see McMullen 1985), and capitalized operating rights were worth only 15 to 20 percent of revenues in the trucking industry in the 1970s (American Trucking Associations 1974; ICC 1980). The transfer of rents from the owners of capital in these industries to consumers was small—perhaps $400 million in the case of trucking and a negligible amount in the case of airlines.

The major losers in airline and trucking deregulation were the unionized employees of these two industries. Table 1 provides data on average hourly earnings and employment in these two deregulated industries and several others that have avoided congressional

---

[7] See Wynns (1984) for an excellent discussion of the evolution of telephone regulation.

TABLE 1

AVERAGE HOURLY EARNINGS, NONSUPERVISORY WORKERS, AND EMPLOYMENT IN SELECTED INDUSTRIES, 1975–84

Year	Nonfarm Private Sector	Trucking	Airlines	Radio & TV	Communications: Services	Communications: Equipment
		Average Hourly Earnings (Dollars per Hour)				
1975	4.53	6.00	7.22	5.10	5.54	5.25
1980	6.66	9.18	9.55	7.44	8.51	7.94
1984	8.33	10.46	11.60	9.68	11.31	10.78
		Percentage Change				
1975–84	83.9	74.3	60.7	89.8	104.2	105.3
1980–84	25.1	13.9	21.5	30.1	32.9	35.8
		Total Employment (Thousands)				
1975	62,259	1108	326	154	1176	457
1980	74,486	1284	402	202	1356	551
1984	78,187	1300	419	230	1387	615
		Percentage Change				
1975–84	25.6	17.3	28.5	49.4	17.9	34.6
1980–84	5.0	1.2	4.2	13.9	2.3	11.6

SOURCE: Bureau of Labor Statistics, *Employment and Earnings*.

surgery. The difference between hourly earnings in trucking and airlines and earnings elsewhere in the economy suggests that truckers and airline employees have clearly lost in deregulation. Trucking wages rose by only about half of the nonfarm private average in the 1980–84 period, while airline wages rose by 80 percent of this broad average. In the industries not deregulated by Congress, broadcasting and telecommunications, wage increases were substantially above the average for the economy.

Regulation may allow workers to bargain for more lenient work rules and higher wages. This was surely true for the airlines and may have been so for trucking. As Table 1 shows, employment growth in trucking and airlines has been below the average for the private economy since 1980, and broadcasting has been above the average. The rapid substitution of capital for labor caused by the electronics revolution apparently has kept employment growth low in the telephone industry and, therefore, in the aggregate of all communications services.

In the case of airlines, Bureau of Labor Statistics data show very little loss in real annual wages for flight attendants and mechanics. Only the pilots have suffered real income losses since 1980, but even they may be recouping some of these losses now. However, the number of hours worked has probably increased for flight crews as the new competition from nonunion carriers has forced the older, established carriers to reduce total labor costs.

Labor also has been the loser in transportation deregulation. An ICC (1980) report, issued before the 1980 legislation that deregulated trucking, predicted that truckers' wages would be reduced by 21 percent in five years by deregulation. Despite this startling prediction, Congress passed the legislation.

Given the level of wages in the trucking and airlines industries under the regime of regulation, it is hardly surprising that competitive pressures have pushed them back toward the average for the nonfarm private economy. But why were the unions involved and the union movement in general so impotent in fending off deregulation? One explanation is that the union movement had peaked by the mid-1950s.[8] By the late 1970s, the share of the labor force in unions had declined substantially, and many of the heavily unionized industries were under attack from imports. As a result, the union movement had precious little capital to devote to legislative battles for the airlines and trucking—especially the latter, given the status of the Teamsters within the labor movement.

Deregulation Without Legislation

The de facto deregulation of telephones, cable television, and financial institutions was achieved without the active participation of Congress. In some cases the regulatory authorities or the courts effected the deregulation, in others a combination of unforeseen circumstances was responsible. Although political forces may have been involved to some extent in these exercises, it is difficult to argue that concerted collective action was responsible for the abolition or reform of decades of rent-creating regulation.

Telephones

In the case of telephones—the most important example of deregulation in terms of its contribution to social product—the changes in regulatory policy seem totally unguided by a consistent political purpose. When the FCC allowed private microwave carriers in 1959, it could not have known that it would be forced to license MCI and other specialized carriers ten years later.[9] When it licensed MCI, it could not have known that it would find itself with no defense against the company's unauthorized entry into long-distance (switched-message) service.[10] And when it failed to block MCI's entry into traditional long-distance service, it had no policy, nor even a methodology, for setting rates for MCI's connections with the local telephone companies.[11]

---

[8] Bureau of Labor Statistics data show that the share of union members in the private labor force peaked in 1954.

The failure of the FCC to foresee the problems that competitive entry would create led to conflicts between AT&T and the new competitors that the commission could not arbitrate. The competitors challenged every AT&T attempt to reduce its competitive rates, but the FCC had no idea of the relative costs of different services on the AT&T network. As a result, the FCC was unable to approve AT&T tariffs because the commission had no framework or data on which to base such decisions.

AT&T also controlled the new competitors' access to customers through its operating companies. When the Justice Department filed an antitrust suit because of AT&T's use of exclusionary practices, the commission lost control of telephone policy.[12] The antitrust decree that broke up AT&T in 1982 was not the result of a direct political process.[13] Indeed, it was the inadvertent outcome of a series of inadvertent results from regulation.

The question remains of why definitive, legislated deregulation has not occurred in the telephone industry. In the 1960s and 1970s, federal-state regulators created a system of pricing access to local connections for long-distance calls that paid the local exchange carriers far more than the cost of the connection (see Wynns 1984). For example, in 1982 interstate telephone calls accounted for 8 percent of the minutes of telephone use in the country, yet 26 percent of the $39 billion of total accounting costs of telephone service were allocated to interstate calls (Wynns 1984). The pricing formula used to allocate this $10 billion per year in revenues greatly benefited many rural states at the expense of states with large urban populations. Moreover, since long-distance access was overpriced, and because businesses accounted for a disproportionate share of long-distance calls, business telephones generally cross-subsidized residential service. Thus, the pricing system that developed without legislative guidance led to multibillion dollar annual rent transfers between states, from business users to residential users, and from urban to rural areas.

---

[9] See Wiley (1984) for a brief review of the landmark cases in telephone regulation.

[10] The FCC tried to block MCI's entry into switched long-distance service, but it failed to convince the courts that it had a satisfactory rationale for doing so.

[11] For more than 15 years, the FCC was unable to determine that any AT&T tariff was lawful because it simply could not divine AT&T's costs for individual services.

[12] U.S. v. AT&T et al. Civil Action 74-1698 (D.D.C. 20 November 1974).

[13] U.S. v. AT&T et al. (D.D.C. 11 August 1982). Decision by Judge Green on proposed settlement.

Even though Congress is not responsible for the distortions in telephone pricing, it has found it difficult to pursue deregulatory legislation that would lead to more efficient telephone rates. In fact, Congress has been the major obstacle to the FCC's attempt to set more efficient rates for access to the telephone network. In this case, the rural interests, small businesses, and vocal defenders of the consumer's right to low monthly rates have prevailed over urban and large business users and, incidentally, sound economics.

Cable Television

Cable television provides a less dramatic example of deregulation without legislation or even legislative guidance. In the 1960s the FCC began to limit cable's right to compete with broadcast stations, on the rather spurious grounds that such competition might destroy local public-service broadcasting.[14] The television station licensees enjoyed enormous rents, and they successfully lobbied the FCC to protect them from any new competition, even though Congress seemed to stand aside.

To protect broadcasters, the FCC erected complex rules governing the number and variety of signals that a cable system could carry, but these rules were abolished over a four-year period beginning in 1975 without any new legislation or apparent change in the political strengths of the affected parties (Besen and Crandall 1981). Pay cable rules were invalidated by the Court of Appeals in 1976,[15] and the commission refused to revisit the issue, despite the continuing objection of broadcasters to this form of competition. It is difficult to find a significant change in the economic landscape or in costs of organizing common interest groups that would explain the dramatic shifts from no regulation to a regulatory stranglehold on cable and back again to virtually no federal regulation in just 14 years.

Depository Institutions

Financial deregulation provides yet another example of deregulation without changes in legislation, albeit a less perplexing one. As interest rates soared following the Federal Reserve's tightening of money in 1979, thrift institutions were faced with unprecedented disintermediation. This increased the pressure on regulatory authorities to allow thrifts to offer high-yielding money market instruments to stem the outflow of deposits. Negotiated orders of withdrawal (NOW) accounts began to undermine the prohibition on interest rates for commercial bank demand deposits and the limits on time-deposit interest prescribed by Regulation Q. Eventually, all thrifts and commercial banks were permitted to compete for deposits without regulatory limits on interest rates (see Carron 1982, chap. 1).

---

[14] See Besen and Crandall (1981) for a review of the history of cable television regulation.

[15] Home Box Office v. FCC (567 F 2d 9), 1977.

Similar deregulation has not occurred, however, on the asset side of financial institutions. While regulation has been liberalized somewhat, there are still important limitations on the portfolios of thrifts and commercial banks, partly because of the moral hazard problems created by deposit insurance.

In sum, much of the important deregulation that has occurred in the last decade has not been due to a decline in the political power of rent seekers before the legislature. Indeed, I contend that because of the large rent transfers created by regulation in these industries, deregulatory legislation was impossible.

Deregulation in some of these industries has been inadvertent, and in others it has been forced by events and court decisions, which are, one could argue, less influenced by political coalitions of common interest groups than is legislation. It is possible that the decline of regulation in the late 1970s and early 1980s was simply an example of rapid technological and economic change rendering old regulatory policies obsolete. This, of course, does not explain why the interests that benefited from regulation could not persuade Congress to reestablish their cartels or otherwise restore their rents through new legislation.

These examples of substantial deregulation demonstrate that where large rents were created by regulation, Congress has been generally unable to enact deregulatory statutes. Nevertheless, deregulation of one variety or another occurred anyway. In other cases, such as television broadcasting, old natural gas, and the merchant marine, regulation continues in full flower, in large part because Congress cannot take away the rents that regulation has created. In the case of television and natural gas, these rents have been enormous; it would be difficult for Congress to deregulate by bribing the losers because the bribes would have to be so large.

Health-Safety-Environmental Regulation

For those inclined to believe that a general political-ideological shift in the country is responsible for the deregulation of the 1970s and 1980s, it is sobering to consider the growth of federal health-safety-environmental regulation during this period.

A brief listing of the major statutes in this area and the agencies they created illustrates the steady march of increased social regulation in the 1970s.[16] In 1970 the Environmental Protection Agency (EPA) was formed by executive order after the passage of the Clean Air Act Amendments of that year. Similarly, the Occupational Safety and Health Administration (OSHA) was created by the 1970 Occupational Safety and Health Act. The Federal Water Pollution Control Amendments were passed in 1972, the same year that the Consumer Product Safety Commission was established to administer four statutes enacted in earlier years. In 1974 Congress passed the Safe Drinking Water Act. Concern about toxic substances and solid waste led to the passage of the Toxic Substances Control Act and the Resource Conservation and Recovery Act in 1976. In 1977, both the Clean Air Act and the Federal Water Pollution Control Act were amended again, adding further complicated standards-setting criteria for EPA. Finally, in 1980, the Superfund, or Comprehensive Response, Compensation, and Liability Act, was passed, empowering EPA to supervise the cleaning up of toxic waste sites, in part with the assistance of a multibillion dollar federal fund accumulated from taxes on petroleum and chemical companies.

In virtually all of these new regulatory programs, Congress instructed the regulatory agencies to set detailed technology-based standards. These standards vary among industries and even among sources within an industry. They are often tighter for new sources than for older sources. The Clean Air Act requires stricter standards for areas with clean air than for areas with dirty air. Some statutes allow a cost-benefit trade-off, others strictly forbid it. If one believes that the economic deregulation of the 1970s was the result of Americans tiring of government controls and longing for a return to markets, he is forced to believe also that Congress and the electorate had a large blind spot when it came to handling problems of health, safety, and the environment.

Rent Seeking and Social Regulation

One might have thought that the Republican victory in 1980 would presage the start of a deregulatory wave in social regulation similar to that which occurred in economic regulation in the 1975–80 period. If the costs of social regulation are at least partially absorbed by business, we might expect the Republicans to relax this type of regulation and begin to look for more efficient mechanisms for pursuing the stated goals of these programs. Such expectations, of course, have proved groundless; the current administration has done nothing to unwind the complex regulatory programs drafted in haste during the 1970s.

---

[16] See Crandall (1986) for a more complete listing.

The failure of the Reagan administration, with its business constituency, to propose major changes in the important social regulatory statutes suggests that there is little business support for repeal or thoroughgoing reform of these programs. This could simply reflect the declining real compliance costs associated with these programs since the late 1970s, when environmental control costs peaked (Table 2). Or it could be that the indirect benefits of these programs for some businesses are substantial, whether anticipated or not.

The environmental programs, which I examine in the remainder of this section, are particularly rife with examples of rent seeking. Others have argued that the Occupational Safety and Health Act protects some producers from competition (Maloney and McCormick 1982). The fuel-economy standards are clearly an example of a regulatory policy being subverted by rent seeking. And the pesticides program at EPA has served to block entry into markets in which patents have expired.

TABLE 2

OUTLAYS ON POLLUTION ABATEMENT IN CONSTANT DOLLARS, 1972–82
(BILLIONS OF 1972 DOLLARS)

Year	Total	Households	Business	Government
1972	18.4	1.5	11.5	5.4
1973	20.6	2.0	12.9	5.8
1974	21.3	2.1	12.9	6.3
1975	23.0	2.6	13.5	6.9
1976	24.3	2.9	14.3	7.2
1977	24.8	2.9	14.9	7.0
1978	26.3	3.1	15.6	7.6
1979	26.9	3.1	16.3	7.5
1980	26.4	3.2	16.0	7.2
1981	25.6	3.8	15.7	6.2
1982	24.4	3.9	14.8	5.8

Note: Individual columns may not add to total because of rounding.

SOURCE: Farber et al. (1984, p. 28).

Environmental Policy

Current environmental policy imposes very large costs on the public through the imposition of technology-based standards on prospective or actual polluters. The total cost of air and water pollution control is estimated to be nearly $40 billion per year (Farber et al. 1984). Despite these enormous costs, few in Congress or elsewhere seem interested in measuring the impact of these programs on pollution.

Reports by the General Accounting Office that there are no satisfactory measures of air quality to guide such assessments are met with a deafening silence from Congress.[17] Although there is some evidence that air quality improved in the 1970s, it appears to have improved at a slower rate than in the 1960s (Crandall 1983, p. 20). Water quality also has improved very little since the mid-1970s.[18] If improving the environment were the most important objective of these programs, why would Congress and the programs' defenders be so uninterested in their results?

Current environmental policy has produced only limited improvements in the environment, but there is little support for changing any of the major statutes. Environmentalists and business groups seem to agree that wholesale reforms are either unnecessary or unwise. This may be the natural result of a policy that is designed to discourage growth through its effect on new investment.

The most severe impacts of air and water pollution policy are on new capacity. This is the result of both the tighter standards that apply to new sources, particularly for air pollution, and EPA's and the states' poor record of enforcement against existing sources (Crandall 1983, chap. 3) Congress has instructed EPA to be much more severe in designing new-source standards for air pollution, particularly in high-growth areas of the country. This is done under the guise of protecting pristine environments and promoting equity and efficiency.

It should be easier to design a new plant to be clean than to retrofit an older one. But new-source standards go much farther. They penalize new sources by imposing higher control costs on them per unit abatement than upon older sources. The data in Table 3 show that the ratio of air-pollution control costs to value added is higher in high-growth states than in low-growth states.

---

[17] There are several of these critical reports. See, for example, General Accounting Office (1982b).

[18] See Council on Environmental Quality (various years).

TABLE 3

AIR POLLUTION CONTROL COSTS PER THOUSAND DOLLARS OF VALUE ADDED IN EIGHT INDUSTRIES, 1977

	Frost Belt						Sun Belt						
Industry[a]	North-east	Middle Atlantic	East North Central	West North Central	Avg.	Value Added, 1972–77[b]	South Atlantic	East South Central	West South Central	Moun-tain	Pacific	Avg.	Value Added, 1972–77[b]
Food Processing (SIC 20)	0.42	0.90	1.27	1.80	1.25	53.0	0.72	0.93	0.70	0.84	0.69	0.74	63.4
Paper (SIC 26)	3.32	1.89	2.81	2.63	2.58	10.3	13.60	11.99	8.67	1.95	7.85	10.81	78.3
Chemicals (SIC 28)	1.80	3.85	4.07	4.60	3.90	58.2	5.59	10.30	8.73	6.72	3.96	7.44	94.0
Refining (SIC 29)	—	36.70	23.80	12.70	26.97	200.3	22.50	—	37.10	16.10	57.80	42.52	238.0
Stone and Clay Products (SIC 32)	4.05	7.49	5.76	8.92	6.95	47.6	7.27	8.97	8.76	8.71	10.30	8.78	60.5
Metals (SIC 33)	2.93	19.36	15.70	13.90	16.20	54.6	21.10	18.80	21.40	136.00	19.40	24.52	72.6
Machinery (SIC 34)	1.52	1.16	0.69	0.99	0.90	63.6	0.48	1.59	0.64	5.35	1.56	1.09	91.0
Transport. Equip. (SIC 37)	0.46	1.96	1.07	0.57	1.09	66.8	0.38	0.19	0.39	—	0.81	0.65	50.1

[a] Standard industrial classification (SIC) numbers in parentheses. The data in this table represent total outlays and value added in each industry in the states for which the Census Bureau reports the requisite information. Coverage ranges from 66 percent of value added in Frost Belt states in SIC 29 to 99 percent of value added in Frost Belt states in SIC 37. In all but three of the sixteen average entries, more than 90 percent of value added is included.

[b] Percentage growth in value added.

SOURCE: Bureau of the Census.

The reason for the severity of new-source standards is found in the politics of environmental voting (Crandall 1983, chap. 7). Fearing the continuing shift of industry to the Sun Belt, congressmen from northern industrial states have been the most consistent supporters of environmental policy (Pashigian 1985). The provision of the 1977 Clean Air Act Amendments that requires areas with clean air to impose rigorous standards and procedures on prospective new sources was given greater support by congressmen from northern urban areas than by those from states with cleaner air. Clearly, clean-air policy is an important weapon in preventing further flight of industry to the Sun Belt and even in creating entry barriers by raising the price of entry into a number of industries. Both causes are likely to attract congressmen from industrial areas of the country.

The most stunning example of rent seeking in environmental policy involves the mandatory scrubbing provisions for new sources of sulfur oxides that were written into the 1977 Clean Air Act Amendments (Ackerman and Hassler 1981). All new fossil-fuel burning boilers are required to use stack-gas scrubbers, regardless of the sulfur content of the fuel they burn. This provision discourages the use of low-sulfur fuel and thereby increases the demand for high-sulfur coal from the Midwest and Appalachia—a curious environmental goal. Equally important, however, is that this provision increases the cost of electric power in western and southwestern states that have ample quantities of cheap low-sulfur bituminous or sub-bituminous coal. This explains why northern congressmen with no dirty coal in their districts are so intent on protecting the coal mining industry east of the Mississippi.

A simulation conducted by EPA during its 1978 rule making on standards for new sources of sulfur oxides demonstrated the regional bias of the full-scrubbing provision (Table 4). The West South Central states suffer an 11 to 12 percent increase in electric utility rates because of the new-source standard for sulfur oxides, while the lower Great Lakes states incur an increase of only 0.3 to 4.8 percent.

Even more curious is the impact of full scrubbing on emissions. Because this strict standard discourages utilities from replacing dirty old boilers, EPA was able to show that a full scrubbing standard is not only substantially more expensive than a less strict (partial-scrubbing) standard, but that it actually leads to greater emissions (Table 5). EPA finally adopted the weaker, partial-scrubbing standard, but not without considerable opposition from environmentalists, who supported a standard that creates more pollution and costs several billions of dollars more per year. Even EPA's simulation fails to

TABLE 4

Effects of Full Scrubbing of Sulfur Dioxide on Regional Electricity Rates, 1995
(Cents per Kilowatt-Hour in 1975 Prices)

		Price in 1995			
		Moderate Growth		Rapid Growth	
Region	Price in 1976	Without Mandatory Scrubbing	With Full Scrubbing	Without Mandatory Scrubbing	With Full Scrubbing
New England	3.96	4.23	4.30 (1.7)[a]	4.31	4.32 (0.2)
Middle Atlantic	3.75	3.58	3.65 (2.0)	3.83	3.91 (2.1)
East North Central	2.56	3.11	3.12 (0.3)	3.32	3.48 (4.8)
West North Central	2.57	2.73	2.78 (1.8)	2.95	3.11 (5.4)
South Atlantic	2.89	3.03	3.08 (1.7)	3.27	3.42 (4.6)
East South Central	1.68	1.32	1.35 (2.3)	1.42	1.46 (2.8)
West South Central	1.99	2.92	3.24 (11.0)	2.91	3.26 (12.0)
North Mountain	1.37	2.02	2.09 (3.5)	2.30	2.47 (7.4)
South Mountain	2.52	2.67	2.77 (3.7)	2.91	2.96 (1.7)
Pacific	2.11	2.75	2.80 (0.7)	2.90	2.93 (1.0)

[a] Numbers in parentheses are percentage increases resulting from full scrubbing.

Source: EPA, "Background Information for Proposed SO_2 Emission Standards, Electricity Steam Generating Units." July 1978, pp. 7–44.

TABLE 5

IMPACT OF ALTERNATIVE SCRUBBER REQUIREMENTS ON EMISSIONS, COAL CAPACITY, OIL USE, AND CONTROL COSTS OF ELECTRIC UTILITIES, 1995

Description	1977 Standards[a]	Full Scrubbing (90 Percent Removal)	Final Standard: Dry Scrubbing Option (70 Percent Minimum Removal)
National Emissions (millions of tons)	23.8	20.7	20.5
Regional Emissions (millions of tons)			
East and Southeast	11.2	10.1	9.7
Midwest	8.3	7.9	8.0
West South Central	2.6	1.7	1.7
West	1.7	1.0	1.1
Coal Capacity (gigawatts)	554	520	537
Oil Consumption in Utilities (millions of barrels per day)	1.2	1.6	1.4
Incremental Annualized Costs of New Standards (billions of 1978 dollars)	—	4.4	3.3

[a] Ceiling of 1.2 pounds per million BTUs.

SOURCE: EPA, "New Stationary Sources Performance Standards, Electric Utility Steam Generating Units," *Federal Register* 44 (11 June 1979): 33608–09.

capture the excess emissions caused by the inevitable breakdowns of scrubbers in utilities burning high-sulfur coal.

If environmental policy were truly concerned with the level of sulfur oxides emissions, it would regulate or tax the emissions (or the sulfur input). Instead, the current policy actually increases the sulfur oxide and acid rain problem. When Congress tried to pass legislation on acid-rain in 1984, it found that its dirty-coal/clean-air coalition would not countenance true environmental control. Congressmen from the Midwest, where power plants emit enormous amounts of sulfur oxides, were not likely to vote for a program that imposes control costs in proportion to the magnitude of the problem. But these congressional districts supplied the votes for most of the existing environmental statutes. By using the Clean Air Act to stifle Sun Belt growth, the representatives from this area have implicitly helped create the acid rain problem in the Northeast and Midwest. Instead of controlling actual emissions, they voted for a statute designed to slow the exploitation of clean coal reserves in the West while promoting the burning of dirty eastern and midwestern coal. They are not now likely to countenance a true environmental policy.

Automobile fuel economy

When enacted in 1975, the Corporate Average Fuel Economy Standards (CAFE) seemed relatively innocuous. Oil prices had been rising dramatically in 1973–74, and automobile companies were being given the wrong signals by the federal government's oil price controls (Crandall et al. 1986). By 1985, however, the CAFE program looked much different. Gasoline prices had been falling for four years, and the major concern was over how far oil prices might fall in the future.

Despite the changed environment, there is no support for abolishing the program—not even from the auto manufacturers. General Motors and Ford face the prospect of fines of several hundred million dollars per year if the standard remains at its 1985 level of 27.5 miles per gallon (Table 6). These two companies, therefore, want the standard relaxed to 26 mpg. Chrysler, on the other hand, is satisfied with the 27.5 mpg standard because it offers few large cars for sale. Even though its cars are less fuel-efficient than similar cars offered by GM or Ford, Chrysler wants the current standard retained (Crandall et al. 1986). This would allow Chrysler, the one company that did not have the foresight or financial wherewithal to continue producing large cars that the market now demands, to use the government to tax the other two auto makers for having the ability and foresight to produce large cars.

TABLE 6

CORPORATE AVERAGE FUEL ECONOMY FOR SELECTED U.S. AND IMPORTED CARS
(MILES PER GALLON)

	Actual 1985	Preliminary 1986
Government Standard	27.5	26.0
U.S. Automobiles:		
AMC	33.5	26.2
Chrysler	27.9	27.7
Ford	26.3	26.4
General Motors	25.5	26.2
Imports:		
Honda	33.9	34.5
Nissan	29.4	28.9
Toyota	32.9	32.2
BMW	25.8	25.2
MG-Jaguar	19.3	19.1
Mercedes-Benz	23.0	—
Peugeot	24.7	24.6
Renault	28.6	26.2
Saab	25.8	—
Volvo	26.5	—

SOURCE: Department of Transportation

Were there no CAFE program, U.S. car manufacturers would be importing more small cars from Japan or Korea because their U.S. plants are not competitive in these lines. With CAFE, however, such a strategy would be very expensive to Ford or GM because the CAFE standards apply separately to a company's domestically produced cars and its imports. GM and Ford need small car production in the United States to raise their domestic CAFE performance. Each mile per gallon that they fall below the standard costs them $50 per automobile produced. Thus, GM could easily accumulate annual fines of $200 to $400 million just for missing the standard by 1 or 2 miles per gallon. The United Auto Workers, therefore, sees CAFE as a mechanism for obtaining protection for U.S. small cars without resort to formal trade policy.[19]

It is reasonable to ask why Ford and GM are not arguing for the abolition of CAFE altogether. One possibility is that a 26 mpg standard is difficult for them, but much more of a barrier to imports from the larger-car producers in Europe. Many of these foreign companies are having difficulty meeting the CAFE standard, and some are forced to offer a large share of diesel engines just to satisfy the regulation. Thus far, the only company to pay CAFE fines is Jaguar.

---

[19] Henderson (1985) makes this point.

Pesticides

Pesticides regulation was transferred to EPA in 1971. A major issue since then has involved the rights of producers to sell pesticides whose patents have expired. The 1975 amendments to the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA) require the new producer to compensate the original patent holder and government licensee for a share of the costs of licensing or of the value of the license. The issue of whether it is the cost or the value of the license that must be compensated remains unsettled, but very important.

On occasion, pesticide manufacturers have successfully used FIFRA after the expiration of their patent to delay for years the manufacture of pesticides by new producers. The law requires an initial attempt at negotiating the compensation due the original patent holder and then final arbitration. In some cases this process has taken as much as five years, thereby greatly extending the effective life of the patent. If the courts ultimately rule that compensation must be based on the original licensee's loss of monopoly rents due to the new entrant, the patent life will be essentially extended forever.

The follow-on licensing procedures have constantly been challenged in the courts, and at several points the entire process was held in abeyance, pending court decisions. Incumbents, therefore, can delay new entrants almost indefinitely by threatening or using legal challenges to any new entrant. Such a strategy would not be available without FIFRA regulation for a firm with an expired patent.

Occupational Safety and Health

A few recent studies (Bartel and Thomas 1985a; Bartel and Thomas 1985b) have concluded that the Occupational Safety and Health Act is a mechanism for large firms to make competition difficult for smaller firms. Most major occupational safety and health standards are technological standards that require the installation of capital equipment. Adjustments in work practices and personal protection devices are generally frowned upon by OSHA regulators.

Some studies suggest that OSHA regulation has been used by certain large manufacturers to create rents for themselves. Maloney and McCormick (1982) have shown that cotton-dust regulations actually benefited some large textile companies. OSHA regulation may also have given unions greater bargaining power by limiting the range of wage-safety trade-offs that nonunion firms may offer.

The Prospects for Reforming Social Regulation

The above discussion does little more than identify the rent-seeking aspects of social regulation. The most important opportunities lie in the environmental area, simply because environmental regulation dwarfs all other social regulation in its impact on business and the economy. But a brief review of other new regulatory programs suggests that Congress may have succeeded in transferring substantial wealth through these programs.

If earlier experience with economic deregulation provides any guidance, we should not expect much change in the newer social regulatory programs that have succeeded in creating large rents for organized groups within our society. These rents have been the motivating force behind environmental regulation, but the evidence is less conclusive for most of the other programs. Even if economic rents have been the inadvertent effects of regulation, however, they will serve as a weighty barrier to future attempts to rationalize or alter these regulatory programs.

It is an illusion to think that reform of environmental regulation simply awaits definitive evidence that the programs are inefficient or, even worse, ineffective. The response to this kind of evidence thus far is not very encouraging. There is substantial evidence that air pollution policy is inefficient, biased against new sources, and poorly enforced, but its proponents quickly set aside all legislative initiatives for reform.[20]

Every attempt to change the most inefficient and costly provisions of the 1977 Clean Air Act—the new source standards for sulfur oxides—is met with a weak response that a few thousand dirty, dangerous coal jobs might be lost.[21] Surely, no one believes that such light parries are sufficient to defend a program that may be brutally effective in restraining economic growth. Something far more important explains the refusal of Congress to change the basic design of environmental policy: the protection of old industries in the Northeast and Midwest.

Congress's refusal to tackle economic deregulation in cases where the regulatory system created large rents for sellers or certain classes of consumers does not bode well for attempts to reform social regulation. It is not necessary for environmental policy to reduce pollution or OSHA regulation to reduce occupational injury rates if there are other "benefits" to these programs.

---

[20] See Crandall and Portney (1984) for a discussion of this problem.

[21] See Congressional Budget Office (1982) for a discussion of the very small effects of efficient alternatives on the geographical distribution of coal production.

If my theory is correct, well-meaning economists may toil for decades demonstrating the folly of environmental policy with as little effect as they have had in reforming merchant-marine or television regulation. This does not mean that they should not try, but their success will depend on something other than their ability to persuade congressmen from the Northeast and Midwest that a restoration of economic growth in Texas should be their overriding concern.

References

Ackerman, Bruce A., and Hassler, William T. *Clean Air/Dirty Coal or How the Clean Air Act Became a Multibillion Dollar Bail-Out for High-Sulfur Coal Producers and What Should Be Done About It.* New Haven: Yale University Press, 1981.

American Trucking Associations. *Accounting for Motor Carrier Operating Rights.* Washington, D.C.: ATA, 1974.

Bartel, Ann P., and Thomas, Lacy Glenn. "Direct and Indirect Effects of Regulation: A New Look at OSHA's Impact." *Journal of Law and Economics* 28 (April 1985a): 1–26.

Bartel, Ann P., and Thomas, Lacy Glenn. "The Costs and Benefits of OSHA-Induced Investments in Employee Safety and Health." In *Worker's Compensation Benefits: Adequacy, Equity and Efficiency.* Edited by John D. Worral and David Appel. Ithaca, N.Y.: ILR Press, 1985b.

Besen, Stanley M., and Crandall, Robert W. "The Deregulation of Cable Television." *Law and Contemporary Problems* 44 (Winter 1981): 77–124.

Besen, Stanley M. et al. *Misregulating Television.* Chicago: University of Chicago Press, 1984.

Breyer, Stephen G. *Regulation and Its Reform.* Cambridge: Harvard University Press, 1982.

Breyer, Stephen G., and MacAvoy, Paul W. *Energy Regulation by the Federal Power Commission.* Washington, D.C.: Brookings Institution, 1974.

Broadman, Harry. "Competition in Natural Gas Pipeline Wellhead Supply Purchases." Resources for the Future Discussion Paper EM-85-05. November 1985.

Carron, Andrew. *The Plight of the Thrift Institutions.* Washington, D.C.: Brookings Institution, 1982,

Congressional Budget Office. *The Clean Air Act, the Electric Utilities, and the Coal Market.* Washington, D.C.: Government Printing Office, April 1982.

Council on Environmental Quality. *Environmental Quality.* Annual Report. Washington, D.C.: Government Printing Office, various years.

Crandall, Robert W. "Regulation of Broadcasting: How Costly is the 'Public Interest'?" *Regulation* (January–February 1978): 31–39.

Crandall, Robert W. *Controlling Industrial Pollution.* Washington, D.C.: Brookings Institution, 1983.

Crandall, Robert W., and Portney, Paul R. "Environmental Policy." In *Natural Resources and Environment: The Reagan Approach.* Edited by Paul R. Portney. Washington, D.C.: Urban Institute Press, 1984.

Crandall, Robert W. "Conflicting Trends in Regulation, or Why Did the 1970s Happen?" Paper delivered at the annual convention of the Association of American Law Schools, New Orleans, 7 January 1986.

Crandall, Robert W. et al. *Regulating the Automobile.* Washington, D.C.: Brookings Institution, 1986.

Derthick, Martha, and Quirk, Paul J. *The Politics of Deregulation.* Washington, D.C.: Brookings Institution, 1985.

Farber, Kit et al. "Pollution Abatement and Control Expenditures, 1972–82." *Survey of Current Business,* February 1984.

General Accounting Office [GAO]. *Changes in Federal Maritime Regulation Can Increase Efficiency and Reduce Costs in the Ocean Liner Shipping Industry.* Washington, D.C.: GAO, 2 July 1982a.

General Accounting Office. [GAO]. *Problems in Air Quality Monitoring System Affect Data Reliability.* Washington, D.C.: GAO, September 1982b.

Henderson, David. "The Economics of Fuel Economy Standards." *Regulation* (January–February 1985): 45–48.

Hilton, George W. "The Consistency of the Interstate Commerce Act." *Journal of Law and Economics* 9 (October 1966): 87–114.

ICC [Interstate Commerce Commission]. *An Analysis of Rates and Costs in the Motor Carrier Industry.* Office of Policy and Analysis. Washington, D.C.: Government Printing Office, April 1980.

Jantscher, Gerald. *Bread Upon the Waters.* Washington, D.C.: Brookings Institution, 1972.

Kolko, Gabriel. *Railroads and Regulation, 1877–1916.* Princeton: Princeton University Press, 1965.

McMullen, B. Starr. "Trunk Airline Financial Requirements and Economic Performance." In *Research in Transportation Economics,* vol. 2. Edited by Theodore E. Keeler. Greenwich, Conn.: JAI Press, 1985.

Maloney, Michael, and McCormick, Robert E. "A Positive Theory of Environmental Quality Regulation." *Journal of Law and Economics* 25 (April 1982): 99–124.

Noll, Roger G.; Peck, Merton J.; and McGowan, John J. *Economic Aspects of Television Regulation.* Washington, D.C.: Brookings Institution, 1973.

Pashigian, B. Peter. "Environmental Protection: Whose Self Interests Are Being Served?" *Economic Inquiry* 23 (October 1985): 551–84.

Peltzman, Sam. "Toward a More General Theory of Regulation." *Journal of Law and Economics* 19 (August 1976): 211–40.

Stigler, George J. "The Theory of Economic Regulation." *Bell Journal of Economics and Management Science* 2 (Spring 1971): 3–21.

Wiley, Richard E. "The End of Monopoly." In *Disconnecting Bell: The Impact of the AT&T Divestiture.* Edited by Harry M. Shooshan, Jr. New York: Pergamon Press, 1984.

Wynns, Peyton. *The Changing Telephone Industry: Access Charges, Universal Service, and Local Rates.* Washington, D.C.: Congressional Budget Office, 1984.

INTERGENERATIONAL TRANSFERS AND SUPER IRA'S

Peter J. Ferrara

Social Security, including Medicare, accounts for over 50 percent of federal domestic outlays, and almost one-third of total federal spending. National defense and debt interest expenditures, when coupled with Social Security payments, account for about 70 percent of total federal spending. Clearly, the size and scope of the federal government will never be substantially reduced without addressing Social Security.

The huge amounts of federal spending through Social Security should be especially troubling because, of all federal programs, it has the clearest, most widely utilized, private sector alternatives, including pensions, Individual Retirement Accounts (IRAs), life insurance, and health insurance. As Milton Friedman has long argued, there is no reason why all the functions of Social Security must be performed in the public sector.[1] It is indeed a truly radical departure from a private, free market economic system to require almost all Americans to rely on the government for the bulk of their income for a major portion of their lives—their retirement.

Given the huge size and scope of Social Security, the program has now become one of the foremost restrictions on economic freedom in American life. The maximum annual Social Security tax, including both employer and employee shares, has grown from $60 in 1949, $189 in 1958, and $348 as late as 1965, to $6,006 today, and it will be almost $8,000 by the end of the decade. Requiring today's workers to invest so heavily for their retirement and insurance protection only through Social Security deprives them of the freedom to control major portions of their own income, and significantly limits their freedom to enjoy the fruits of their own labor.

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is a Washington attorney and an Adjunct Scholar of the Cato Institute.

[1] See, for example, Friedman (1962, p. 182).

Fundamental reform of Social Security must become a primary concern for market-oriented policymakers. This paper examines why the case for such reform should now have broad public appeal. It also advances a politically appealing reform approach that should have substantial prospects for success. Finally, transition issues involved in the privatization of Social Security are discussed.

The Case for Fundamental Reform

The compelling case for fundamental reform of Social Security arises from the overwhelming problems of the program. The most important of these is just now starting to be recognized. Although the program is still a relatively good deal for today's elderly, it has become a very poor deal for today's young workers, given the enormous tax burdens they now face over their working years. Even if these young workers receive all the benefits promised to them by Social Security today, they will still be receiving low, below-market returns, in many cases negative, on taxes paid into the program.

This problem is not a chance development, but a natural, inevitable result of Social Security's fundamental structure and operation. Social Security is said to operate on a pay-as-you-go basis. That is, the taxes paid into the program today are not saved and invested to finance the future benefits of today's young workers, but instead are immediately paid out to finance the benefits of current beneficiaries. The taxes of the next generation of workers are to be used to finance the benefits promised today's workers.

In the early years of Social Security, workers and their employers only had to pay the program's taxes for a few years before retirement. The tax burden in those years was also quite low, as we have noted. But because the program operates on a pay-as-you-go basis, the benefits paid to these early retirees were not limited to what could be paid based on the past taxes paid by them and their employers; rather, they were paid full benefits out of the taxes paid by those still working. Such benefits consequently represented a high return on the taxes they and their employers did pay.

Over time, however, the rate of return naturally began to fall as workers and their employers began paying higher taxes for more of their working years. For today's retirees, the program's benefits still represent above-market returns on taxes paid into the system. But, as noted, today's young workers and their employers must pay taxes of several thousand dollars a year into the program for their entire careers. These workers no longer enjoy any of the beneficial aspects of the start-up phase of the program. Instead, since no investments are made through the pay-as-you-go system, these workers lose the full market returns they could earn if their funds had been privately invested. The pay-as-you-go system can only pay returns to the extent tax revenues are increased over time, and such returns simply cannot keep up with private capital market returns. For most young workers entering the work force today, the real rate of return offered by Social Security under current law is less than 1 to 1.5 percent. For many two-earner couples and single workers, who will predominate in this generation, the Social Security rate of return is close to zero or even negative.[2]

An examination of stock returns from 1926 (when data were first compiled) to 1985 indicates that the composite real rate of return on all stocks on the Standard and Poor's 500 was 6.6 percent. The composite real rate of return on smaller company stocks on the New York Stock Exchange was even higher, at 9.3 percent.[3] If young workers entering the work force today could invest all their Social Security tax money, including the employer's share, in IRAs and earn a 6 percent real rate of return, which is somewhat less than the average return earned in the stock market over the last 60 years, most would receive three to six times the retirement benefits promised under Social Security, while at least matching the other types of benefits provided by the program. At a 4 percent real return, most would receive two to three times the retirement benefits promised by Social Security.[4] Besides these higher benefits, the system of private market investments supporting them would also generate substantial additional tax revenues to finance other government goods and services or general tax reduction.[5] Social Security generates no revenues for these purposes.

Moreover, whether Social Security can pay even the inadequate returns and benefits promised to young workers under current law remains questionable. Under the Social Security Administration's own most widely cited (intermediate) Alternative IIB projections, if we add all of the program's trust funds together and assume any can draw from the others as needed, then the entire combined program (OASDHI) runs short of funds by 2026, just before those entering the work force today will be retiring. By 2035, the program's total expenditures would be almost 50 percent greater than total revenues each year.[6] Paying all the benefits promised to today's young workers under these projections would require a total Social Security payroll tax rate, including both employee and employer shares, over 23 percent, compared with 14.3 percent today.[7]

---

[2] See Ferrara and Lott (1985) and Ferrara (1986) for a more thorough discussion of these issues.

[3] Both statistics are from Ibbotson Associates (1986, Exhibit 10A, p. 45).

[4] Ferrara (1986).

[5] These revenues result from taxation at the corporate or business level on the full, before-tax rate of return produced by the private system's capital investments. Such taxation results from the corporate income tax, state and local taxes, and numerous other taxes. For further discussion, see Ferrara and Lott (1985); Ferrara (1986).

The Alternative IIB assumptions, however, may be overly optimistic.[8] Many independent observers believe that the Social Security Administration's so-called pessimistic Alternative III assumptions are more realistic.[9] These assumptions are certainly at least quite plausible.

Under the Alternative III projections the entire, combined program runs short of funds sufficient to pay full benefits by 1998. By 2035, when those entering the work force today will be in retirement, Social Security's total annual expenditures would be two and one-third times more than annual revenues.[10] Paying all the benefits promised to today's young workers would require an astounding Social Security payroll tax rate of over 37 percent.[11] This would mean a total Social Security annual tax, split between employer and employee, of $7,500 for a worker earning $20,000.

The Social Security payroll tax is already too high, seriously hampering economic growth and limiting job opportunities for today's young workers. To the extent this tax is borne by employers, it discourages them from hiring; to the extent it is borne by employees, it discourages them from working. Either way, the result is less employment and therefore less total output. The payroll tax is nothing more than a tax on employment, and, here as elsewhere, the result of taxing something is that there is less of it.

As noted above, the maximum annual Social Security tax is over $6,000 this year, and by the end of the decade it will be almost $8,000. For at least half of all workers covered by Social Security, the combined payroll tax is more than they pay in federal income tax.[12] In 1985 payroll tax revenues, drawn primarily from low and moderate income workers, were over 70 percent greater than total federal corporate and indirect business tax revenues.[13] A married worker with two children earning $7,700 this year will pay about $550 in payroll taxes, with another $550 from his employer that probably comes out of his wages as well, before paying a dime in federal income taxes. In a society deeply concerned about employment opportunities, this tax burden on employment is ludicrous. Yet, without fundamental reform the future probably holds in store only further payroll tax increases.

---

[6] All of these projections are calculated from Ballantyne (1985); Social Security Administration (1985a); Social Security Administration (1985b).

[7] Social Security Administration (1985a, Appendix E).

[8] See Ferrara (1985, chaps. 2 and 3) for a more thorough discussion of the optimism behind these assumptions.

[9] See, for example, Ricardo-Campbell (1984); Robertson (1985); Roberts (1985); Peterson (1982); Capra, Skepardas, and Kubarych (1982).

[10] Calculated from the sources cited in footnote 6.

[11] Social Security Administration (1985a, Appendix E).

[12] Bridges (1981).

Social Security may also harm the economy by substantially reducing national savings. Though a fierce debate has raged in the academic community over the impact of Social Security on national savings in the past,[14] the program's negative impact on national savings today should be readily apparent. Social Security forces workers to provide for retirement through a pay-as-you-go system, which provides no savings to the economy. Whether this has a negative effect on savings depends on how workers would provide for their retirement in the absence of Social Security. To the extent workers would rely on intergenerational transfers from their children, then Social Security would have no negative effect on savings, as it would merely be replacing a private pay-as-you-go system that involves no savings with a public one. But to the extent workers would provide for their retirement through savings during their working years, then Social Security would be reducing savings, by replacing a private system that adds to the nation's savings with a public system that does not.

It is clear that workers today supplement Social Security primarily through private sector savings plans, such as pensions, IRAs, 401Ks, Keoghs, and insurance policies, rather than through voluntary support from their children. Indeed, today's workers are having fewer children per capita than at any time in history, indicating that children are not viewed as an essential or primary means of retirement support. Consequently, Social Security appears to be primarily substituting for private savings vehicles, and reducing national savings accordingly. Given the huge size of Social Security, this impact of the program in reducing national savings could be quite large. Less saving means in turn less capital investment, fewer new jobs, and slower economic growth.

In addition, the Social Security benefit structure is riddled with inequities that render the program unsuitable to our modern pluralistic society. Workers are not paid equal returns on past taxes paid into the program. In particular, the program pays discriminatorily lower returns to two-earner couples, workers without children, and single workers. Blacks and other minorities with below average life expectancies also tend to receive lower returns on this account because they live fewer years in retirement, yet they are subject to the same taxes throughout their working years. A white male at birth today can expect to live 50 percent longer in retirement than a black male, and therefore receive 50 percent more in retirement benefits. Moreover, blacks as a group are significantly younger than whites, and since Social Security offers a worse deal to younger workers, the program disadvantages blacks on this account as well.

---

[13] Council of Economic Advisors (1986).

[14] See Ferrara (1980, chap. 3; 1982, chap 3; 1985, chap. 4) for discussion of this debate.

The problems with Social Security that most disturb market-oriented policymakers would also be important to many members of the general public. Those who wish to see a smaller federal government burden on society will recognize that this cannot be accomplished without reforming Social Security. As the private alternatives to Social Security continue to grow robustly, more people will question why workers must be forced to invest so heavily only through Social Security. As the payroll tax continues to grow past its already Olympian proportions, more and more workers will resent the restrictions on economic freedom involved in the program. Taken together, these and other problems of Social Security add up to a truly compelling case for fundamental reform.[15]

Super IRAs: A Populist Proposal

Fundamental reform of Social Security does not require imposing sacrifices on the elderly. Quite the contrary, appropriate reform would strengthen Social Security and assure today's elderly their benefits, while providing new opportunities for today's young workers to enjoy a more secure and prosperous retirement, and to work in a more healthy economy today.

This can be accomplished by giving workers the option of substituting expanded "Super" IRAs for at least part of their Social Security coverage to start. A Super IRA option would allow workers to contribute additional amounts to their IRAs, up to some reasonable initial limit. In return for these contributions, workers would receive a 100 percent income tax credit equal to the amount of such contributions. That is, workers would receive a full dollar off their income taxes for every dollar they contributed to the Super IRA. Employers would be allowed to make some or all the contributions on behalf of the worker, and take the tax credit accordingly.

---

[15] See Ferrara (1980, 1982, 1985) for further discussion of these and other problems.

Workers who exercise this option would then have their future Social Security retirement benefits (OASI) reduced to the extent they did so. For example, a worker who contributed an amount to his Super IRA each year for his entire career equal to 20 percent of his Social Security retirement taxes (OASI) would have his retirement benefits reduced by 20 percent. But the accumulated funds in the Super IRAs would pay benefits that would likely exceed the forgone Social Security benefits, leaving workers with higher benefits overall.

Later, the Super IRA option could be expanded. Workers and their employers could be allowed to contribute additional funds to their Super IRAs for the purchase of private life insurance, again in return for 100 percent income tax credits. To the extent each worker did so, if he died before age 65 his survivors would receive the private life insurance benefits rather than Social Security survivors insurance benefits. Workers and their employers could also be allowed to contribute additional funds for the purchase of private disability insurance, again in return for full income tax credits. To the extent each worker did so, he would receive the private disability insurance benefits in the event of disability in lieu of Social Security disability benefits. Similarly, workers could be allowed to contribute additional funds to their Super IRAs for the purchase of private medical insurance in retirement to substitute for Medicare. Ultimately, each worker would have complete freedom to choose how much to rely on the Super IRAs and how much on Social Security.

The purpose of the 100 percent tax credits is, in effect, to give workers their money back to the extent they agree to forgo future Social Security benefits and rely on their own Super IRAs. But it is crucial to recognize that the tax credits are taken against income taxes, not the payroll taxes that finance Social Security. Therefore, Social Security payroll tax revenues would not be reduced in any way, and would continue to flow into the program in full to finance benefits for today's elderly. The Super IRA option would simply result in a loss of income tax revenues.

The option could begin quite small to avoid a substantial loss of revenue, and then be slowly expanded. The revenue loss would eventually be offset completely by reduced Social Security expenditures, as workers relied more on Super IRAs and less on Social Security. Long before this point, moreover, the revenue loss could be eliminated on net due to new revenues generated from increased investment through IRAs. In addition, from the beginning there would be increased savings through the Super IRAs equal to the amount of the temporary net revenue loss, since the tax credits are only allowed for Super IRA savings.[16] So even if the government had to borrow entirely to cover the temporary net revenue loss, there would be no net increase in the government borrowing drain on private savings.

Social Security itself would be greatly strengthened by such reform, improving the ability of the program to pay promised benefits. This is because while the program's payroll tax revenues are maintained in full, the program's expenditures in the future would be reduced substantially as workers relied more on Super IRAs than on Social Security. If the Super IRA option were expanded rapidly enough, the long-term financing problems of the program could be eliminated, even under pessimistic assumptions. Indeed, with the Super IRA option eventually expanded to the maximum, Social Security expenditures would likely be reduced dramatically, allowing room for sharp reduction in payroll tax rates.

Workers could always choose to rely entirely on the strengthened Social Security system. There would be no reduction in Social Security benefits for such workers, or for today's elderly. But those workers who did opt for the Super IRAs could expect much higher retirement benefits. These benefits would also be completely equitable, with each worker receiving back what he and his employer paid in, plus market investment returns, on an actuarial basis. The Super IRA benefits, moreover, would be financed on a fully funded basis, which would secure them against the financial instability inherent in Social Security's unfunded pay-as-you-go system.

Workers would also have much greater freedom of choice and control over their own incomes through the Super IRAs. Although workers would still be required to provide for their retirement and insurance contingencies through some means, the Super IRAs would allow them to choose and control the investments and insurance purchases to satisfy these requirements. Workers would consequently be able to tailor individual packages of investments and insurance coverage to suit personal needs and preferences. Further, workers could choose their retirement age after the 59 ½ minimum age for IRA benefits under current law. They could also choose to leave some of their Super IRA funds to their heirs, which they cannot do with Social Security. Super IRAs in addition allow workers instantaneous vesting and maximum portability. With its individualized flexibility and enhanced personal freedom, the Super IRA option along with Social Security is clearly an overall system far better suited to our rapidly changing, highly mobile, highly diverse, modern society than the rigid, 1930s-oriented Social Security system alone.

---

[16] To minimize the danger of a mere shifting of existing savings into Super IRAs, workers should be prohibited from withdrawing before retirement any Super IRA contributions for which a credit was received, and associated returns. Workers could not then shift existing savings held for nonretirement purposes into Super IRAs, as such savings once contributed could not be used for nonretirement purposes. Because Social Security benefits would be reduced for credited Super IRA contributions, the Super IRA savings would be needed to replace those lost benefits, and therefore would not be available to perform the purposes of other retirement savings. As a result, any shifting of existing savings into Super IRAs should be negligible.

The reform would also have important benefits for the economy. National savings could be sharply increased through the funds paid into Super IRAs, with a fully expanded Super IRA option potentially producing hundreds of billions in increased savings each year. Such a savings increase would in turn produce new jobs and increased economic growth. Eventual payroll tax reductions would also stimulate job creation and economic growth.

The reform would also create new opportunities for the poor, because it would give them control over some capital through their Super IRAs. If a lifelong minimum wage earner and his employer could pay into a Super IRA what would otherwise be paid into Social Security, then, at the same returns that have historically been earned in the stock market, he would accumulate almost $300,000 in today's dollars by retirement, even while providing for the preretirement survivors and disability benefits provided by Social Security.[17] This fund could pay him, out of continuing returns alone, more than he is currently offered under Social Security, and the fund would provide a solid foundation for the economic advancement of his children.

The Supplemental Security Income (SSI) program would continue to provide means-tested, general revenue financed welfare benefits to the elderly poor, ensuring that retirement income would not fall below a basic minimum. A substantial portion of benefits paid through Social Security today may be considered welfare benefits, as they are not based on past tax payments into the program, but on certain criteria thought to indicate need. Because Social Security benefits are paid without a means test, however, this welfare assistance goes to many who are not in need. But the more workers rely on Super IRAs, the more welfare assistance will be paid only through the means-tested SSI program, channeling welfare benefits only to those who are actually poor and eliminating the current substantial waste of welfare benefits paid through Social Security.

---

[17] See Ferrara and Lott (1985); Ferrara (1986).

In addition, the more workers across the whole economy are allowed to accumulate assets in their Super IRAs in lieu of Social Security, the more equal the national distribution of wealth would become. This is because workers would be accumulating substantial assets in their IRAs more equally distributed than the current distribution of wealth. If all workers paid into Super IRAs rather than Social Security, the national concentration of wealth would be reduced by one-third.[18] This would be achieved not by redistributing existing wealth, but by providing for the creation of new wealth equally distributed. Through the private IRA investments, each worker would develop a substantial ownership stake in America's business and industry. This could revolutionize political attitudes. Instead of retirees developing a psychology of dependence on big government, as with Social Security, they would tend to support the new foundation of their livelihood—private enterprise and free markets—as would average workers watching their stake in the private economy grow.

Finally, the reform would sharply reduce spending, as workers began relying more on Super IRAs than on Social Security. With a complete option to rely on Super IRAs, federal spending could potentially be reduced by more than one-fourth. No other single reform offers the potential for such a dramatic reduction in federal spending without all the pain of benefit cuts, but rather simply through the individual choice of workers.

It should be emphasized that the entire Social Security monolith need not be taken on all at once. Each of its components could be addressed separately through the Super IRA concept, with the complete option available only after many years. For example, reform could begin with the Social Security survivors insurance program. Social Security pays $10 to $15 billion annually in benefits to the survivors of young workers. Through these benefits, the government is simply preempting much of the private life insurance market, forcing workers to "buy" their life insurance from Social Security through payroll taxes.

A simple proposal could be advanced doing nothing more than allowing workers and their employers the option of contributing extra funds to IRAs to purchase private life insurance in return for tax credits. To the extent each worker exercised this option, his survivors (if he died before age 65) would rely on the private insurance rather than Social Security survivors' insurance. Expenditure reductions offsetting the short-term revenue loss would occur quite rapidly under this option. The survivors of workers who exercised the option in the first year and died in that year would rely on the private insurance benefits rather than Social Security, thereby reducing the program's expenditures. The short-term revenue gap could, as a result, be eliminated on net in less than a decade.

---

[18] See Feldstein (1976a).

Alternatively, reform could focus initially on the chaotic Social Security disability insurance program. Government studies in 1979 indicated that 20–30 percent of the program's disability beneficiaries were, in fact, not disabled. In 1980, Congress mandated a review of each beneficiary's case. When the Social Security Administration started cutting off ineligible beneficiaries, however, a tremendous political outcry developed. The ensuing backlash was aided considerably by bureaucratic ineptitude, as the government appeared incapable of focusing its termination notices solely or even primarily on the 20–30 percent who were actually not disabled. In the face of the outcry, Congress backed down and stopped the reviews, and put most of the terminated beneficiaries back on the rolls.

This episode illustrates that the government cannot run a disability program because the decision as to who is disabled becomes too politicized. These decisions can only be made objectively in the private market by insurance companies subject to competition. Companies that are too lax in accepting disability claims will have unnecessarily high costs and be unable to compete. Companies that are too harsh will develop bad reputations and lose business. A reform that merely allowed workers to buy disability insurance through their IRAs as a substitute for Social Security would consequently be attractive all by itself. Expenditure reductions offsetting the short-term revenue loss would again accrue rapidly, as with a survivors insurance option.

Similarly, a reform effort could focus initially only on Medicare, which suffers from enormous long-term financing problems. Under so-called intermediate projections by the Social Security Administration, by the time today's young workers retire there would only be enough payroll tax revenues to finance 40 percent of projected Medicare hospital insurance benefits. Under the so-called pessimistic assumptions, paying all the hospital insurance benefits promised to today's young workers would require a higher payroll tax rate than for all of Social Security combined today.[19]

An attractive reform could involve allowing workers and their employers to contribute additional funds to IRAs, in return for tax credits, with the funds to be used for medical expenses in retirement. The Medicare deductibles would then be increased for each worker to the extent he exercised this option. With the tax credits taken against income taxes rather than payroll taxes, the long-term financing problems of Medicare could be eliminated. Expenditures would be reduced through the increased deductibles, and program revenues would be maintained in full. This financing problem would be solved, moreover, without cutting the program's benefits for today's elderly or raising payroll taxes for today's workers.

---

[19] Social Security Administration (1985a, Appendix E).

Political Prospects

On our present course, Social Security will continue to provide nothing but trouble for market-oriented policymakers. It will stand as an uncuttable leviathan in the federal budget. Statists will continue to push for expansion of the system, leaving allies of the market on the defensive. Periodic financial crises will leave market partisans resisting inexorable payroll tax increases with nothing to offer as an alternative but politically disastrous benefit cuts. This is playing the Social Security issue on the home field of the Liberal Welfare State.

The Super IRA concept offers allies of the market the opportunity to break out of these defensive dilemmas and shift the Social Security debate to new ground. It avoids both cuts in the program's benefits for today's elderly and increases in the program's taxes for today's workers, and instead simply offers workers the freedom to choose a better deal in the private sector. This is precisely the grounds on which the public always accepts market-oriented policies.

The proposed reform should appeal especially to young workers, for the current system is such a poor deal for them. It would be particularly appealing to the politically conscious young, urban professionals ("yuppies"), who receive especially low returns from Social Security because of their higher than average incomes and the prevalence of single workers and two-earner couples among them.

The reform should also appeal to the elderly. It leaves their benefits completely intact and strengthens the financial foundations of the program. In addition, the opportunities created by the reform for today's young workers will also be important to the elderly, who are concerned about the legacy they will leave their children and grandchildren.

Assuring benefits for today's elderly while creating new opportunities for today's young workers precisely matches broadly held public opinions among both young and old regarding Social Security. Fealty to the Social Security system per se is nonexistent, except among a small band of statist ideologues. What both the young and old support are the promised benefits for today's retirees. Both young and old are broadly open to the suggestion that there is a better way to do it for the future.

The proposed Super IRA concept provides a better way by expanding the Social Security framework to provide for a greater role for the private sector. It is a purely positive approach that increases the freedom and options of workers. It modernizes and liberalizes the current system. The benefits of the reform indeed are overwhelming in comparison with the short-term, temporary costs. The proposed Super IRA concept consequently offers a politically appealing reform approach that should have substantial prospects for success.

Transition Issues

Some critics of the idea insist, however, that shifting from a public pay-as-you-go system like Social Security to a private, fully funded system like Super IRAs will never be politically feasible because of a so-called double-payment problem. They contend that the generation working during the transition period would have to pay for two retirements, by paying for its own through the private system, while continuing to pay benefits to those already retired on Social Security. But this argument inaccurately characterizes the nature and costs of such a transition.

Such a reform would involve an additional cost for the initial working generation only to the extent that the reform involves an increase in savings, and that is the same cost involved in any savings increase. Suppose starting next year workers were allowed to withdraw $20 billion in Social Security taxes annually to save in private IRAs. Future Social Security benefits of these workers would be reduced in proportion to the reduction in their Social Security taxes, but the benefits for today's elderly would continue to be paid in full. The loss in revenue to pay the benefits of the currently retired would be equal to the increased savings in the IRAs. If the government simply increased its borrowing to cover this revenue loss and pay the benefits of today's elderly, there would be neither a net loss or increase in savings. At the same time, there would be no extra cost to the current working generation to pay for "two retirements," since the government borrowed the needed funds to continue to pay benefits to the current elderly.

If, however, the government covered the $20 billion revenue loss by raising taxes or cutting other government expenditures, rather than by increasing borrowing, there would be a $20 billion increase in savings. The cost of this savings increase would be $20 billion in reduced present consumption due to increased taxes or reduced spending. But this very same cost would be involved in any $20 billion increase in savings no matter how it came about. Any $20 billion increase in savings must, by definition, entail a $20 billion reduction in present consumption.

This savings increase, moreover, brings the same long-term returns and increased production as any other savings increase. That is, the new $20 billion in increased savings invested through the IRAs would generate increased production equal to the full before-tax rate of return to capital just like any other invested savings.

The cost of shifting from the pay-as-you-go system to a private fully funded system, whether in the private or public sector, is simply the cost of paying for the increased savings involved in the fully funded system. This cannot be characterized as paying twice for your retirement and, therefore, always involving a bad deal. Workers are paying for increased savings which involve benefits as well as costs. The benefits include the long-term returns and increased income resulting from the increased savings, as well as, in the case of a shift to the private sector, the other benefits of a private system. One clearly cannot determine a priori that the trade-off between these costs and benefits, inherent in any savings increase, will necessarily be perceived as a bad deal. How workers will perceive this trade-off depends on how they subjectively value and weigh such costs and benefits.

It should be recognized that shifting from a public pay-as-you-go system to a private fully funded system involves the same transition costs as shifting to a public fully funded system, that is, shifting to fully funded Social Security. But one would not say that fully funding Social Security involves "paying for two retirements." It simply involves paying for the increased savings to fund the system fully. Clearly, one cannot determine a priori that fully funding Social Security would always necessarily appear to be a bad deal. It depends on how workers value the short-term costs of paying for the increased savings versus the long-term returns and increased income resulting from such savings, as well as the other benefits of full funding, such as enhanced security.

Indeed, Martin Feldstein has argued for more than a decade that Social Security should be shifted from a pay-as-you-go system to a fully funded system in the public sector, precisely because he believes the long-term returns from the increased savings involved in the fully-funded system are clearly worth the short-term costs of paying for such savings.[20] Feldstein's position is directly the opposite of those who say that shifting to a private fully funded system will always appear unattractive, since the transition costs of shifting to a fully funded system are the same whether the system is in the public or private sector. There are actually more benefits associated with shifting to a private-sector system than to a fully funded federal system, which should make it even more worthwhile.

---

[20] See Feldstein (1974, 1975, 1976b, 1976c, 1977).

Those who believe that the aim of public policy should be to increase savings are implicitly saying that the short-term costs of paying for the increased savings are well worth the long-term returns produced by such savings. For those who hold this view, it follows that shifting from Social Security to a private fully funded system is also well worth the costs.[21] Through such reform, whatever increase in savings occurs is produced with the same total costs and total benefits as any other savings increase of the same magnitude. Moreover, this reform produces, at no extra cost, many other benefits that result from performing the functions of Social Security through the private sector. The reform should therefore be the best and most beneficial method of producing any such savings increase deemed warranted.

Workers themselves have indicated that a shift from a pay-as-you-go system to a fully funded system can be perceived as well worthwhile, by carrying out just such a shift in the private sector retirement supplements to Social Security. Decades ago, the private sector itself operated primarily on a pay-as-you-go basis. When the elderly reached retirement, they depended on their children for direct support. Over the years, however, this practice has changed dramatically. Today, as we have noted, the predominant means for private retirement support is fully funded, savings-based vehicles, such as pensions, IRAs, 401Ks, Keoghs, insurance, and just plain private savings, with little direct financial support from children expected. For today's workers planning for their future retirement, this seems to be overwhelmingly so.

This transition in the private sector involved the same sort of transition as would be involved in shifting Social Security to a fully funded basis in the public sector or private sector. As incomes rose, workers who were supporting their elderly parents began also saving for their retirement, and expecting less retirement support from their own children. They preceived this change as a good deal, given all the benefits involved, despite the extra cost of the increased savings. The benefits included not only the higher returns and income and enhanced security workers could expect relying on such increased saving. Through such savings these workers also removed a major financial burden from their children, and gained increased independence and freedom for themselves in retirement—benefits which also would result from shifting from Social Security to a private, fully funded system. Obtaining all these benefits through increased private savings is one way workers have chosen to use their increased personal incomes over the years.

---

[21] The only danger from this view is that the shift may produce more additional savings than is worthwhile. If Social Security itself is substantially reducing savings, however, then it is unlikely that the shift would produce more of a savings increase than deemed warranted. In any event, it is quite easy to reduce any savings increase resulting from the transition. The transition can be taken in smaller steps, or the government can increase its borrowing during the transition.

Social Security in effect has prevented this transition from occurring in the portion of retirement support under its domain. It has frozen workers into an outdated pay-as-you-go system, when their own actions indicate they would shift to a fully funded system.

One might ask if workers would find the savings increase involved in a transition from a public pay-as-you-go system to a private fully funded system worthwhile, why haven't they already increased savings, bearing the costs and reaping the rewards? The answer is that individual savers may not find the costs of increased savings worth the return they would individually receive, after the heavy burden of taxation on capital investment returns. But voters may still prefer collectively to bear the costs of increased savings in return for the full before-tax return to capital they would collectively enjoy as well as for the short-term economic benefits that may result from a general savings increase, such as improved economic growth or the creation of new jobs. The proposed Social Security reform involves just such a collective offer. Moreover, the voters would have all the other benefits of shifting Social Security to the private sector to consider with such an offer, which a single saver individually would not have. In addition, Social Security itself may be a distorting factor that has reduced saving. In this case, the transition to a fully funded private system may just involve restoring the savings which individual savers together would have preferred in the absence of Social Security.

It should be noted that all the transition costs of shifting the enormous Social Security system to a private fully funded system do not have to be imposed on one generation. If such a shift would involve too much of a savings increase for any one generation, the transition could be spread out over several generations. Only a portion of Social Security could be shifted to the private system in each generation. Alternatively, the entire system could be shifted and the government could borrow some of the funds to pay off the elderly during the transition, with the debt repaid by future generations. This would reduce the savings increase produced by the initial generation and spread the burden of the total savings increase over future generations.

There is an additional cost that applies only to the initial working generation at the time of any transition from a public pay-as-you-go system to a private fully funded system. If this generation itself pays the full benefits to the elderly under Social Security at the time, rather than paying those benefits by borrowing, then under the current system this generation would itself have become entitled to full Social Security benefits. But in shifting to the private fully funded system, this generation would be giving up the Social Security benefits and relying on the benefits of the private system instead. For this first generation, therefore, the value of these forgone Social Security benefits must be subtracted from the overall benefits of the reform in evaluating whether the reform is attractive. This is again a cost of the transition that occurs only to the extent that the transition results in increased savings, with the initial generation itself paying for the benefits of the elderly at the time, rather than borrowing to pay such costs and offsetting the increased savings in the private fully funded system.

The loss of these benefits to the first working generation does not change the costs or benefits of the reform in the aggregate. The forgone benefits merely represent the elimination of a redistribution between two generations—the working generation at the time of the reform and the following generation—a redistribution rendered unnecessary by the retirement benefits of the new private system. The elimination of this redistribution does not reduce the increased production resulting from any savings increase produced by the reform. Nevertheless, the elimination of this redistribution results in an effective reduction in the overall benefits of the reform received by the first working generation. This raises the question of whether subtracting the value of these forgone Social Security benefits from the overall benefits of the reform would necessarily make the reform unattractive to the initial working generation.

Recognition of this additional cost does not change the analysis very much. Because for today's young workers and for all future generations, the returns under the private fully funded system will be higher—indeed very much higher—than under Social Security, workers in the initial generation would still on net get strong returns and substantial increases in income, as well as all the other benefits of the reform, in return for bearing the transition costs. Workers would still be getting more in return for paying more. Consequently, one still could not determine a priori that workers in the initial generation would necessarily find the reform unattractive.

Indeed, we can see just how much more the private system's returns and benefits would be. The full amount of benefits produced by the system of private investments is the before-tax, real rate of return to capital. This represents the full value of the increased production resulting from the private system's investments. Even if some of this return is taxed away, that just means some of the benefits are being used to purchase additional government goods and services or reductions in other taxes. The full amount of benefits produced by the private system still must be taken into account, even if some are provided in this form.

Martin Feldstein and others have estimated the full, real, before-tax rate of return to capital in the United States at around 12 percent.[22] This 12 percent return does not represent a return routinely available to individual investors, who receive the lower returns remaining after federal, state, and local taxes are paid. Some investment vehicles also shift some of the profit to others in return for reduced risk. But at least in theory, the tax and investment system could be arranged so that the full before-tax return to capital earned by retirement investments is entirely devoted to retirement benefits. Let us examine such a situation to see at least the significance of the difference between the full before-tax return to capital and the returns offered by Social Security to today's young workers.

As previously noted, for most of today's young workers the real rate of return offered by Social Security is less than 1 to 1.5 percent.[23] Benefits payable by a private fully funded system earning a 12 percent return would be more than 20 times greater than benefits payable by a Social Security system earning a 1.5 percent return.[24] Under these circumstances, even given that the initial generation of workers has to forgo Social Security benefits under the reform, they would still be receiving on net at least an additional 19 times Social Security benefits through the private system in return for bearing the transition costs of the reform.

Clearly, one cannot say a priori that workers would necessarily find this to be a bad deal. The value of the forgone Social Security benefits is quite small relative to the overall benefits of the reform. The loss of this redistribution could be seen as in effect a tax on the full investment returns of the private retirement system, a quite small tax compared with the huge tax burdens regularly applicable to private investment returns. Under any policy to increase savings, individual savers themselves would not be receiving the full benefits produced by their own savings, due to taxation and other factors.

---

[22] Feldstein (1974, 1975, 1976d); Stockfish (1982); Holland and Myers (1979); Gorman (1974).

[23] Ferrara and Lott (1985); Ferrara (1986).

[24] If one invests a certain sum each year in a system paying a 12 percent annual return, and invests an equal sum each year in a system paying a 1.5 percent annual return, after 45 years the total accumulated through the first system would be more than 20 times greater than the total accumulated through the second.

Inevitably, the returns on the private retirement investments would be subject to some taxation. But this would result in the creation of new tax revenues not generated under the current Social Security system. These new tax revenues can be seen as offsetting at least some of the cost of paying benefits to the elderly during the transition. If we assume that one-third of the before-tax private investment returns would be taxed away each year under some tax-preferred retirement system, such as pensions or IRAs, then with all Social Security taxes invested in the private system each year, sufficient new revenues would be generated by taxation of the private system's investments to pay one-half of remaining benefit obligations to the elderly.[25] This would cut the transition cost for the initial working generation in half. At the same time, the workers in this generation would receive through the private system at least seven times the retirement benefits promised by Social Security.[26] Consequently, given that these workers would forgo one time Social Security benefits under the reform, they would still be receiving, in return for transition costs equivalent to 50 percent of Social Security taxes, on net at least an additional six times Social Security benefits through the private system.[27] In other words, under these circumstances the reform would mean that those in the first working generation would pay 50 percent more than under the current system but receive in total seven times the benefits.

---

[25] If the amount to be paid into Social Security were instead paid into the private system, with one-third of the before-tax return taxed away, then in less than 20 years there would be enough tax money generated each year to fund Social Security benefits completely. The tax funds, therefore, would pay more than half of the initial working generation's liability to the elderly over the generation's entire 40-years-plus work span.

[26] With one-third of the full 12 percent return taxed away, workers would receive a return of 8 percent on their retirement investments. If one invests a certain sum each year in a system paying an 8 percent annual return, and invests an equal sum each year in a system paying 1.5 percent annual return, after 45 years the total accumulated through the first system would be seven times greater than the total accumulated through the second.

[27] Since one-half of the benefit obligations to the elderly would be paid by the taxes generated by private investments, an amount equal only to 50 percent of the Social Security taxes otherwise to be paid by the initial working generation would be sufficient to pay off the rest of the benefit obligations of the elderly.

Moreover, because the benefits of the private system are potentially so high, workers and their employers could be allowed to save less each year for retirement through the private system than they would be required to pay into Social Security. They could, for example, be required to pay into the private system only one-half of what they would be mandated to pay into Social Security. With the same taxation of returns as indicated above, under these circumstances the private system would pay 3.5 times the benefits of Social Security and generate sufficient revenues to pay off 25 percent of benefit obligations to the elderly. After paying off all other remaining benefit obligations to the elderly as well as paying into the private system, the reform would mean that those in the first working generation would pay 25 percent more than under the current system, but receive in total 3.5 times the benefits.

It should be emphasized that the burden on the first working generation could always be reduced by several orders of magnitude, along with the benefits, by shifting only a small portion of Social Security to the private fully funded system. Further portions of the program could be shifted in later generations. Alternatively, in the context of complete reform, the government could again borrow some of the funds to pay off the elderly during the transition, with the borrowing to be paid off by future generations.

In addition, besides the higher monetary benefits offered by a shift from the public Social Security system to a private fully funded system, there are many other important benefits resulting from such reform that also must be weighed by the initial working generation. To begin with, the reform would replace the current pay-as-you-go Social Security system, plagued with major long-term financing problems creating great uncertainty, with a private system which would be far more secure because it is fully funded. The reform would also replace the haphazard, inequitable benefit structure of the current system with completely equitable private benefits offering each worker the same market returns. Workers would also have much greater freedom of choice, independence, flexibility, and control over their own incomes through the private system. As we have noted, they would be able to tailor individual packages of investments and insurance coverage to suit their varying individual needs and preferences.

The reform is also likely to have substantial positive effects on the nation's economy. Any increase in savings would probably have beneficial effects beyond merely the newly generated income represented by the returns on the private investments. The more rapid economic growth produced by such a savings increase would reverberate throughout the economy, likely producing further economic growth, new jobs, and increased employment in a supply-side boom. Eventual reductions in the payroll tax made possible by the reform would also stimulate greater economic growth, creation of new jobs, and higher employment.

Those in the initial working generation may also be expected to value the benefits of the reform for their children. The reform would remove an enormous burden for the children of the initial working generation, allowing them to participate freely in the private sector without extraneous obligations. Many would also value such continuing benefits for all future generations. If people are convinced that it makes much more sense to have a private system rather than Social Security, they will be willing to incur some costs over their lifetimes to set things right for the future.

Indeed, many in the initial generation will value a number of benefits of the reform which may be perceived ideologically. Those who favor limited government and reliance on free markets would find special value in the reform, as it would in effect "denationalize" the large portion of the pension and insurance industries now represented by Social Security, producing a major shift of economic functions from the public sector to the private sector, and sharply reducing federal spending in the process. Many will also value the new opportunities and increased income especially important and beneficial to the poor. Special value will also be seen by many in the broader distribution of wealth and broader ownership of private business and industry resulting from the reform.

The transition process itself is likely to produce some additional benefits. The need to raise funds during the transition to continue paying benefits to the elderly might pressure the government into cutting wasteful, unnecessary spending, or at least into restraining the growth of wasteful spending. Or it might pressure the government into selling off assets it would otherwise keep, releasing such assets to more productive uses in the private sector.

Finally, it must be recognized that the votes of only a majority of the initial working generation are necessary to approve the reform. Those especially sensitive to the above described advantages of the reform would provide the foundation of a pro-reform coalition. It is easy to see, for example, that those ideologically inclined to favor private markets and economic freedom would readily embrace such reform. Moreover, those who receive discriminatorily lower returns from Social Security would probably also join a proreform coalition. Banks, insurance companies, mutual fund companies, stockbrokers, and other financial institutions could also be expected to support it heavily. In addition, many voters might feel relatively immune to any of the transition costs of change. Many might feel that they have the political clout to prevent any increase in their taxes or any cuts in government benefits crucial to them. These voters would also more readily support the reform. Such factors would ease the formation of a successful political coalition in favor of the reform.

Given the wide-ranging benefits and manifold social and political considerations, including many benefits that are purely subjective, it should be clear that one cannot possibly determine a priori that the reform will necessarily be perceived as a bad deal by the initial working generation. Indeed, changing Social Security to a public fully funded system would involve the same costs for the initial working generation as shifting to a private fully funded system. Yet, as we have noted, Feldstein believes that the benefits of such a transition are obviously worth the costs, and these benefits do not include all the advantages of shifting to the private sector. Moreover, the shift in the private sector over the years from pay-as-you-go mechanisms of retirement support, such as family transfers, to fully funded savings vehicles today involved the same costs for the initial working generations undertaking the change. Yet, their own actions indicate that they found the costs to be worth the benefits, and there were not as many benefits as would be involved in shifting from the public to the private sector.

The notion that the reform must be a bad deal stems from the misleading label, "paying twice for retirement," which skews consideration of proposals for reform. The correct label is "paying for the increased savings resulting from the reform," which leads to the realization that whether it is desirable depends on a subjective weighing of the costs and benefits by workers. Whether shifting to a private, fully funded system will be perceived as desirable can be determined only by offering it in the political marketplace and letting workers decide based on their subjective preferences.

Another transition issue is whether anything will be accomplished if, during the shift, the government simply borrows all funds needed during the transition to pay remaining benefit obligations to the elderly. Would Social Security's pay-as-you go system then simply be replaced by a similar tax and transfer scheme conducted under the auspices of explicit federal debt, with no new savings generated in the economy? Instead of paying taxes into Social Security, might workers then just be paying taxes to the government to service the debt, with Social Security benefits replaced by the interest on the debt?

First, even if the transition is financed 100 percent by borrowing, the reform still produces important breakthroughs. The borrowing only explicitly recognizes a debt that already implicitly exists through Social Security—the benefits owed to workers and retirees, or, in other words, the unfunded liabilities of Social Security. The key factor is that these unfunded liabilities would no longer continue to grow as they would under Social Security. As workers start paying into the private system each year and as new workers join the work force paying into the private system, further unfunded liabilities would not be accruing under Social Security, as they would otherwise. Instead, workers would be accruing their additional benefits each year under the fully funded private system. If all workers and retirees opted for the private system on a certain day, with only Social Security benefits accrued as of that day to be paid in the future, then the present value of Social Security liabilities (or debt incurred to pay them off) discounted back to that day would always be the same fixed sum, whereas it would continue to grow if Social Security continued as is.

Over the long run, the reform would eventually generate increased savings on net, as growth in real wages and the working population led the savings accumulated in the private retirement system to grow past the value of old Social Security unfunded liabilities now held in explicit federal debt. The net increased savings would begin slowly and grow slightly each year. Over time, the total amount of the debt incurred to pay off Social Security liabilities would become less significant relative to the growing economy. The total amount of savings generated through the private system would never reach the limits it would have if the transition had not involved any borrowing, unless the federal debt representing such borrowing were paid off in the future. But over time, this difference would also become less significant.

Milton Friedman recognized this in proposing the privatization of Social Security in 1972.[28] He recommended that bonds be issued to all workers and retirees for the amount of their accrued benefit obligations under Social Security. These bonds would then be paid off out of general revenues when cashed in by the workers or retirees for their retirement benefits. The Social Security tax would be abolished immediately, and workers would provide for their retirement from that time onward through the private sector. Friedman argued that the bonds would merely be recognizing explicitly federal debt that already existed implicitly in the unfunded liabilities of Social Security. He contended that the proposed reform would end the accumulation of further benefit obligations under Social Security and allow the private sector to take over thereafter. In regard to all the transition issues we have discussed, Friedman's reform proposal is substantively the same as the Super IRA reform.

---

[28] Cohen and Friedman (1972).

Second, and more important, the goal is not to finance the transition by borrowing. The goal is to finance it by as little borrowing as possible and to pay off in the future whatever borrowing is necessary. Only such a goal will phase in a truly privatized system as quickly and completely as possible. The proposed Super IRA reform, or any similar reform such as the one Friedman has proposed, makes it politically possible to achieve such privatization. The Super IRA reform in particular is a positive, attractive proposal politically. Once it is adopted, in order to complete privatization, politicians do not need to talk about privatizing Social Security or making it voluntary or doing anything in regard to Social Security. They only need to talk about reducing the relative size of the federal deficit and the growth of national debt. The issue is consequently changed from a risky subject politicians fear—overhauling Social Security—to a politically safe subject they routinely campaign on—federal deficits and the national debt.

During the transition under a Super IRA reform, a substantial portion of the continuing benefit obligations to the elderly will be financed by some means other than borrowing. The increased deficit due to the lost revenue resulting from the Super IRA option will lead to some spending reductions that would not have occurred otherwise, to the delay or forgoing of some other tax reductions that would have occurred otherwise, and possibly even to some tax increases that would not have occurred. Such results would naturally stem from routine pressures to maintain total deficit and national debt parameters. Even some such resulting spending reductions and revenue increases to pay the transition costs of the reform will cause the value of the explicit debt incurred to pay off Social Security liabilities to fall far below the trend line of continuing economic growth, rapidly depreciating the value and significance of such debt relative to the economy. Indeed, over the long run, routine political pressures on the total level of deficits and national debt are likely to lead them to return to historical levels as a percent of GNP. In the process, any borrowing to finance the Social Security privatization reform will have, for all practical purposes, been paid off. The Super IRA reform, therefore, charts a politically pragmatic route to Social Security privatization.

Conclusion

The shackles of the welfare state will never be thrown off without addressing the nation's gargantuan social insurance system, including Social Security and Medicare. Market-oriented policymakers must explore means and devise ways to achieve what is clearly the appropriate policy for such programs, that is, shifting their functions primarily to the private sector.

The proposed Super IRA reform is one means by which this can be achieved. Given the enormous problems of Social Security, such fundamental reform can now have broad appeal to the public. Presented properly, it can be politically attractive and ultimately successful.

References

Ballantyne, Harry C. "Long-Range Estimates of Social Security Trust Fund Operation in Dollars." Actuarial Note 125. Social Security Administration, U.S. Department of Health and Human Services, 1985.

Bridges, Benjamin, Jr. "Family Social Security Taxes Compared with Federal Income Taxes, 1979." *Social Security Bulletin* 44 (December 1981): 12–18.

Capra, James R.; Skepardas, Peter D.; and Kubarych, Roger M. "Social Security: An Analysis of Its Problems." Federal Reserve Bank of New York *Quarterly Review* 7 (Autumn 1982): 1–17.

Cohen, Wilbur J., and Friedman, Milton. *Social Security: Universal or Selective?* Washington, D.C.: American Enterprise Institute, 1972.

Council of Economic Advisers. *1986 Economic Report of the President.* Washington, D.C.: Government Printing Office, 1986.

Feldstein, Martin. "The Optimal Financing of Social Security." Discussion Paper No. 388. Cambridge, Mass.: Harvard Institute of Economic Research, 1974.

Feldstein, Martin. "Toward a Reform of Social Security." *Public Interest,* no. 40 (Summer 1975): 75–95.

Feldstein, Martin. "Social Security and the Distribution of Wealth." *Journal of the American Statistical Association* 71 (December 1976a): 800–807.

Feldstein, Martin. "Facing the Social Security Crisis." Discussion Paper No. 477. Cambridge, Mass.: Harvard Institute of Economic Research, 1976b.

Feldstein, Martin. Summary of Testimony on Social Security. Subcommittee on Fiscal Policies, Joint Economic Committee, 27 May 1976c.

Feldstein, Martin. "National Saving in the United States." Discussion Paper No. 506. Cambridge, Mass.: Harvard Institute of Economic Research, 1976d.

Feldstein, Martin. "Strengthening Social Security." Testimony before the House Ways and Means Commmittee. Washington, D.C., May 1977.

Ferrara, Peter J. *Social Security: The Inherent Contradiction.* Washington, D.C.: Cato Institute, 1980.

Ferrara, Peter J. *Social Security: Averting the Crisis.* Washington, D.C.: Cato Institute, 1982.

Ferrara, Peter J., ed. *Social Security: Prospects for Real Reform.* Washington, D.C.: Cato Institute, 1985.

Ferrara, Peter J., and Lott, John R., Jr. "Rates of Return Promised by Social Security to Today's Young Workers." In *Social Security: Prospects for Real Reform*, pp. 13–32. Edited by Peter J. Ferrara (1985).

Ferrara, Peter J. *Social Security Rates of Return for Today's Young Workers*. Washington, D.C.: National Chamber Foundation, 1986.

Friedman, Milton. *Capitalism and Freedom*. Chicago: University of Chicago Press, 1962.

Gorman, J. A. "Nonfinancial Corporations: New Measures of Output and Input." *Survey of Current Business* (March 1974).

Holland, D. M., and Myers, S. "Trends in Corporate Profitability and Capital Costs." In *The Nation's Capital Needs*, pp. 103–89. Edited by R. Lindsay. New York: Committee for Economic Development, 1979.

Ibbotson Associates, Inc. *Stocks, Bonds, Bills and Inflation: 1986 Yearbook*. Chicago: Ibbotson Associates, 1986.

Peterson, Peter J. "The Coming Crash of Social Security." *New York Review of Books* (2 December 1982).

Ricardo-Campbell, Rita. "Social Security Reform: A Mature System in an Aging Society." In *To Promote Prosperity: U.S. Domestic Policy in the Mid-1980s*, pp. 91–123. Edited by John H. Moore. Stanford, Calif.: Hoover Institution Press, 1984.

Roberts, Paul Craig. "Social Security: Myths and Realities." In *Social Security: Prospects for Real Reform*, pp. 59–67. Edited by Peter J. Ferrara (1985).

Robertson, A. Haeworth. "The National Commission's Failure to Achieve Real Reform." In *Social Security: Prospects for Real Reform*, pp. 37–58. Edited by Peter J. Ferrara (1985).

Social Security Administration. *1985 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds*. Washington, D.C., 1985a.

Social Security Administration. *1985 Annual Report of the Board of Trustees of the Federal Hospital Insurance Trust Fund*. Washington, D.C., 1985b.

Stockfish, J. A. "Measuring the Social Rate of Return on Private Investment." In *Discounting for Time and Risk in Energy Policy*, pp. 257–71. Edited by Robert C. Lind. Washington, D.C.: Resources for the Future, 1982.

FERRARA'S SUPER IRA PROPOSAL: A CRITIQUE

A. Haeworth Robertson

There are things that are right and things that are wrong with Peter Ferrara's (1986) paper. In my comment I will discuss examples of both characteristics.

Points of Agreement

Need to Examine the Total Program

When Ferrara talks about Social Security, he correctly refers to both cash benefits and Medicare benefits. Too many analysts and commentators refer only to Social Security's cash benefits when they are reporting on its financial condition, but then refer to the entire program of cash benefits and Medicare benefits when they are talking about the wonders of Social Security. This practice accounts for most of the confusion about whether Social Security will have large deficits or large surpluses in the years ahead.

When we refer to Social Security, we should refer to the program of benefits that people can expect to receive in exchange for paying their Social Security, or FICA, taxes: old-age benefits, survivor benefits, disability benefits, and hospital insurance benefits provided under the Medicare portion of Social Security. These benefits are frequently referred to as OASDI and HI benefits. As analysts studying the appropriateness and viability of Social Security in the future, we should also include the Medicare Supplementary Medical Insurance (SMI) program, even though these benefits are financed by general revenue and premiums paid by participants, and not by the FICA taxes.

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Managing Director of William M. Mercer-Meidinger, Inc. in Washington, D.C., and former Chief Actuary of the Social Security Administration.

A person who retires at age 65 receives monthly benefits under the Social Security program, made up of two parts: (1) A cash annuity, payable monthly for life, adjusted explicitly to reflect changes in the Consumer Price Index; and (2) A medical care annuity, payable monthly for life, the value of which increases implicitly as the cost of medical care increases. The medical care annuity is not paid in cash, but rather in kind—that is, in the form of medical care insurance protection. The approximate monthly value of this insurance protection for HI and SMI benefits can be determined from the annual Trustees Reports. Some examples of estimated average monthly annuities paid in 1985 are shown in Table 1.

For the retired worker alone, the medical care annuity of $190 is 29 percent of the total annuity of $662. For the retired worker and spouse, the medical care annuity of $380 is 33 percent of the total annuity of $1,160. (These examples are based on averages and ignore the differences in male and female per capita medical care costs.)

Medicare is thus a very important part of every retired person's benefits. A reduction in Medicare benefits may be even more burdensome to the beneficiary than a reduction in cash benefits, since it may be more difficult to replace benefits lost as a result of Medicare cuts than it is to replace reductions in cash benefits. So when we talk about Social Security and whether the benefits are appropriate, and whether we will be able to afford the benefits in the future, we should talk about the total program, not simply part of it.

Social Security's Overwhelming Problems

Ferrara makes another very important and, I believe, correct observation when he states, "Fundamental reform of Social Security does not require imposing sacrifices on the elderly" (p. 200). He says there is a compelling case for fundamental reform of Social Security because

TABLE 1

SOCIAL SECURITY AVERAGE MONTHLY ANNUITIES, 1985

Monthly Annuity ($)	Retired Worker over Age 65	Retired Worker and Spouse
Cash Annuity	472	780
Medical-Care Annuity		
HI	128	256
SMI	62	124
Total	662	1,160

SOURCE: Social Security Administration.

of the overwhelming problems of the program, and I believe he is correct.

To further bolster his case, Ferrara cites the irritatingly high present cost of Social Security and the unbearably high projections of future cost. The OASDI and HI parts of Social Security now cost about 14 percent of taxable Social Security earnings. By the time the baby-boomers retire, this cost could well rise to about 23 percent of such earnings under the Alternative II-B (intermediate) assumptions and over 40 percent of earnings under the Alternative III (pessimistic) assumptions. This projected increase would be in addition to the costs of the SMI program.

In my opinion, the Alternative III assumptions are the ones we should use to determine whether it seems reasonable to expect that future benefit promises can be fulfilled under the Social Security program—that is, whether future income will be approximately equal to future outgo. Another way to think of the future imbalance between scheduled tax income and benefit promises is this: under Alternative III assumptions, scheduled taxes would be enough to pay only about 50 percent of the Social Security benefits we have promised during the next 75 years. It is clear we have promised more than we can deliver.

In speaking of the political aspects of Social Security reform, Ferrara makes a very important point when he says (p. 206):

> On our present course, Social Security will continue to provide nothing but trouble for market-oriented policymakers. It will stand as an uncuttable leviathan in the federal budget. Statists will continue to push for expansion of the system, leaving allies of the market on the defensive. Periodic financial crises will leave market partisans resisting inexorable payroll tax increases with nothing to offer as an alternative but politically disastrous benefit cuts. This is playing the Social Security issue on the home field of the Liberal Welfare State.

Experience to date certainly supports Ferrara's analysis of the political aspects of Social Security reform. Thus far, even the market-oriented Reagan administration, whose rhetoric favors individual responsibility and a reduction in the welfare state, has treated Social Security as a sacred cow.

Points of Contention

Returns to Young Workers

Ferrara believes that one of the reasons fundamental reform is necessary is that "Although the program is still a relatively good deal for today's elderly, it has become a very poor deal for today's young workers" (p. 196). I agree that older workers got a better deal than younger workers will get (at least five times as good a deal). But the younger workers' deal may not be so bad as the author suggests and it may not be so bad as to require a fundamental reform.

Ferrara compares a young worker's Social Security benefits with alternative benefits he would receive by investing his and his employer's Social Security taxes privately and earning the "average return earned in the stock market over the last 60 years," and concludes that "most would receive three to six times the retirement benefits promised under Social Security, while at least matching the other types of benefits provided by the program" (p. 197). These calculations were based on a 6 percent real rate of return. I would suggest that it is not appropriate to assume that the average individual can earn a 6 percent real rate of return year in and year out for 50 years or so. Based on a real interest rate of about 2 percent, which somehow seems more credible, the generation of workers currently entering the work force will receive benefits that are roughly equivalent to their taxes, assuming no changes in scheduled taxes and benefits. (This comparison ignores Medicare benefits and taxes.)

The author acknowledges in his paper that "For most young workers entering the work force today, the real rate of return offered by Social Security under current law is less than 1 to 1.5 percent" (p. 197). I doubt that this is such a low rate of return for the new generation of workers that they will demand fundamental reform solely because of the low return. On the other hand the lack of individual equity within this generation could well result in dissention.

The question of whether individuals get their money's worth from their individual taxes is no more relevant to evaluating Social Security than it is to evaluating the public school system or the national defense program or the federal program of highways and bridges. The only reason people ask questions about return on investment under the Social Security program is the program has been misrepresented to them. Also, as Ferrara pointed out, there are private sector alternatives to most of Social Security's benefits but not to many of the other government programs.

Unfortunately, much of the rhetoric used to describe Social Security for the past 50 years has implied that there was a large degree of individual equity: that individuals were paying for their own benefits. Anyone who has studied our Social Security system knows that it is not based on equity among generations or within generations: that is, there is virtually no connection between what one pays in taxes and what one receives in benefits.

Equity is not essential to the operation of a social insurance system. Complete equity may not even be desirable; however, it cannot be long acceptable to provide significantly less equity than is represented to the public to exist. In other words, you cannot fool all the people all the time and that seems to be what the advocates of a "bigger and better" Social Security system have been trying to do.

The Double-Payment Problem

The author spends a large portion of his paper assuring the reader that the "so-called double-payment problem"involved in the transition from a pay-as-you-go system to an advance-funded system is not a real problem. He makes such statements as "there would be no extra cost to the current working generation to pay for 'two retirements' " (p. 207). After several pages of such reassurance, he finally admits, however, that "there is an additional cost that applies only to the initial working generation at the time of any transition from a public pay-as-you-go system to a private fully funded system" (p. 211): namely, that such generation would be paying for two retirements but receiving only the private retirement benefit and forgoing the public retirement benefit. Well, it is only this initial working generation that counts. No generation, particularly the current young generation, is going to knowingly and willingly sacrifice for the benefit of future generations. (A generation that questions the present Social Security system on the grounds of unfairness is unlikely to sacrifice for the benefit of a yet unborn generation.)

Ferrara minimizes this loss to the transition generation by relying on presumed extraordinary real rates of return to produce phenomenal benefits. For example, he states (p. 212):

> Benefits payable by a private fully funded system earning a 12 percent return would be more than 20 times greater than benefits payable by a Social Security system earning a 1.5 percent return. Under these circumstances, even given that the initial generation of workers has to forgo Social Security benefits under the reform, they would still be receiving on net at least an additional 19 times Social Security benefits through the private system. . . .

Later in the paper the author assumes the individual will have part of his 12 percent return taxed away, leaving a net return of only 8 percent, which will result in private system benefits "at least seven times the retirement benefits promised by Social Security" (p. 213).

At the risk of sounding cynical, I will say that I have always been told that if something is too good to be true, it is probably not true. Real interest rates of the magnitude used variously throughout the paper (first 6 percent, then 12 percent, and finally 8 percent) are too good to be true, in my opinion.

Pitfalls of Super IRAs

The author's proposal for Super IRAs would result in the loss of substantial income tax revenues (because of the tax credits granted). He presumes such a loss would be offset by reduced Social Security expenditures, new revenues generated by increased business activity associated with the savings attributable to the Super IRAs, and increased government borrowing (if all else fails). He dismisses the problem of lost revenues too easily, I believe. He states that any necessary additional government borrowing will be painless because of the added saving resulting from the Super IRAs. But this saving cannot be available for loans to the government; for if it is, it cannot generate the large investment returns in the private sector that he is relying on to make his reform proposals palatable.

It seems to me that the crux of Ferrara's proposal is that it will be better for the American public to have a system of retirement and related benefits that is based on individual equity instead of social adequacy, and to save in advance for those benefits, thus increasing the nation's pool of capital and the well-being of the populace. So far, so good. But then he uses assumptions that defy all reason about the investment return on the individual's accumulating retirement funds as well as the increased economic well-being of the entire population that will result from the increased pool of capital. The projected consequences, using these economic assumptions, do not assure me that Super IRAs are the panacea; rather, they tend to foster a suspicion that the proposals must be flawed or else such an optimistic and glowing account of the end result would not be needed to convince me of the merit of the proposals.

Many of the important statements in Ferrara's paper appear to be verified and amplified in the references mentioned in the footnotes; however, most of these references are to his own writings. The paper contains entirely too many unsubstantiated (and incredible) assertions to be considered a rigorous work.

His proposals seem to point in the right general direction, at least according to my own philosophy. Furthermore, they may be well thought out and may work in theory, but this is not evident from the material presented in the paper. It will be difficult for his proposals to be accorded a fair evaluation until:

- The proposals are formulated in more detail (particularly with regard to the large portion of Social Security benefits paid other than upon normal retirement), and presented with more factual backup and less evangelical fervor;

- More realistic and credible assumptions are made about the economic consequences of providing retirement benefits by advance funding rather than a pay-as-you-go method;
- A more rigorous quantitative assessment is made of the consequences of shifting from a pay-as-you-go system to an advance-funded system, including the effect of the revenue reductions arising from the tax credits; and
- More specific transition proposals are formulated that recognize the difficulties posed by the "transition generation."

Conclusion

In addition to the reasons for Social Security reform given in the paper, there is another compelling reason that is perhaps the most important of all. The present Social Security program, with all its complexity and confusion about the benefits it provides, is changing our attitudes about our responsibility for saving and providing for our own future needs and those of our extended family. More and more people believe that their economic needs in time of adversity should and will be met by the government, that is, by someone other than themselves. This change in attitude about responsibility for self can have frightening long-range consequences.

The nation must decide the extent to which it wants its citizens to have freedom of choice and the extent to which it wants to regulate their activities. It can then design an appropriate public policy as to the optimum roles to be played by the three natural sources of retirement income: government, employers and trade unions, and individuals. By properly designing and implementing such a policy, the nation can insure that its citizens' basic economic security needs are met in ways that are consistent with the social and economic environment in which the nation will flourish, not wane. The challenge of finding and implementing the optimum mix that is the most favorable to this end is considerably greater than merely satisfying the population's economic security needs during the next few years.

There is no reason for this country to continue with a social insurance system that is controversial, constantly on the verge of financial collapse, out of phase with the times, and—in my opinion—doomed to ultimate failure. Living with such a system is an unnecessary drain on our collective productivity and psyche. It is eminently more sensible for us to design a social insurance system that is understood and perceived as fair and reasonable by the majority of citizens and that will be considered an aid, rather than a hindrance, to the attainment of a healthy and productive national economy. Young innovative persons—such as Peter Ferrara—who are not afraid to advance new and untested ideas will surely lead us eventually to more rational solutions to all of our problems than we have yet discovered.

Reference

Ferrara, Peter J. "Intergenerational Transfers and Super IRAs." *Cato Journal* 6 (Spring/Summer 1986): 195–220.

THE POLITICAL ECONOMY OF WORK-FOR-WELFARE

S. Anna Kondratas

Introduction

A public commitment to the work ethic and work requirements in public assistance programs is nothing new. Beginning with the parish workhouses of Elizabethan England, the history of welfare reform reveals the inextricably intertwined themes of rendering humane public assistance to the needy, concern that assistance without work requirements fosters dependency, and attempts to define the limits of public obligation and to control the public purse. The vocabulary progresses through time—the tramps and vagrants of one period are the homeless of another, the deserving poor metamorphose into the truly needy, and solutions like apprenticeship yield to ones called job training. The vocabulary changes, but the inherent political and economic dilemmas of welfare stay much the same.

Those dilemmas are rooted in the political and economic traditions of the Anglo-American brand of capitalist democracy. Alexis de Tocqueville (1983, p. 108) brilliantly illustrated the nature of the problem in describing the England of the 1830s:

> In a country where the majority is ill-clothed, ill-housed, ill-fed, who thinks of giving clean clothes, healthy food, comfortable quarters to the poor? The majority of the English, having all these things, regard their absence as a terrible misfortune; society believes itself bound to come to the aid of those who lack them. . . . In England, the average standard of living a man can hope for in the course of his life is higher than in any other country of the world. This greatly facilitates the extension of pauperism in that kingdom.

Since charity is a noble human impulse, de Tocqueville concedes that no idea seems "more beautiful and grander" than that of public

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Schultz Senior Policy Analyst at the Heritage Foundation.

charity. But he insists that reality inevitably must destroy such "illusions," because the very fact that public charity legally bestows permanent rights to assistance is bound to "breed more miseries than it can cure" (p. 119). And the "miseries" that he observed in England, when translated into contemporary terms, included dependency, welfare cheats, family dissolution, lack of motivation, irresponsibility, and most of our other "modern" concerns. He also predicted that special circumstances, such as those in the United States, might keep such ill effects from developing rapidly, but noted that in time they would inevitably develop and "devour the well-being of generations to come." Whatever the cause-and-effect relationships, we certainly cannot claim to have avoided the problems he foresaw.

Tying work requirements to public assistance for the able-bodied has always seemed the obvious solution to the work disincentives and demoralizing effects associated with welfare support, since work is the supposed means to independence and the basis of man's dignity. But once the principle of an entitlement to public assistance is established, work in such a scheme loses its primary purpose as the means of production and becomes instead a condition of entitlement. Instead of being useful, it can become cumbersome. There may be labor shortages in some areas and surpluses in other areas, but the indigent are not always conveniently located near or suited for available jobs. Charitable intentions are insufficient to change economic conditions or endow bureaucrats with decision-making and job-creating capacities superior to the market's, and this fact underlies the make-work and faked-work quality of many work-for-welfare strategies. It has not been the lack of a work requirement that has flawed public charity, but the element of entitlement itself; and thus a work requirement could not change the essential contradiction.

Nonetheless, the history of private charity and public welfare in America shows that the idea of entitlement was never seriously contested (albeit the public responsibility was a local one). And a strong current of belief in the necessity to require work from the able-bodied to avoid corrupting them and burdening society runs through that history. Hence the American preoccupation with separating the helpless from the shiftless, those who deserve society's assistance from those capable of self-support. This preoccupation provides the rationale underlying our complex system of categorical rather than universal assistance. It has also led, because of changing social norms and economic and demographic conditions, to some of our specifically modern welfare conundrums.

The Contemporary Framework

The federal government's involvement in providing welfare income effectively began during the Depression, when the primary objective was to provide a means of subsistence to a large segment of the population that had none at all. Welfare was a substitute for, not an alternative to, the labor market, because for many there was no labor market. The Aid to Dependent Children program, moreover, was initially to benefit widows, who were not expected to be in the labor market and whose lack of a means of support for their children was beyond their control (Burke 1985a, p. 4). In the present, of course, welfare in its many forms operates as a supplement to low earnings or as an alternative to work. And the renamed Aid to Families with Dependent Children (AFDC) program has changed in character. The vast majority of the 3.5 million poor women who head households—households in which more than half of the nation's poor children live—are not widows but divorced, separated, or never-married women, and most of them are on welfare.

Before the 1960s it was generally presumed that women with children were properly unemployable. But the element of personal responsibility for single parenthood as well as the fact that the majority of nonwelfare mothers with young children are in the labor force has resulted in a public reevaluation of the role of AFDC. This is all the more so because about half the women who are employed outside the home perceive that working is a matter of economic necessity for them, and not a matter of choice.[1] Questions of equity obviously will arise when some women with children feel compelled to work, yet the taxes they pay help to enable other women to stay home with their children.

The rising interest in work-for-welfare coincides with the devolution of responsibility for program design to the states since 1981. Federal involvement in welfare since 1935 never stressed work requirements; indeed, work for benefits had been prohibited in the AFDC program until 1962. True, the Works Progress Administration had provided jobs during the Depression, primarily for men, but war and postwar prosperity ended the need for such programs. Many states, however, had continued work requirements for some recipients of state-funded general assistance even after enactment of federal welfare programs. In 1977, 19 states had workfare requirements in their general assistance programs (Shipp 1982, p. 3).

---

[1] See Decision/Making/Information, executive summary of *Nationwide Survey on Women's Issues*, 1983.

One final observation on welfare today should be kept in mind. In spite of the increasing number of antipoverty programs and rising welfare benefits over the past two decades, the aggregate number of AFDC welfare recipients in the United States has remained relatively stable at about 3.5 million cases (between 10 and 11 million recipients) since 1972. There is, of course, considerable turnover in the caseload. Long-term dependency is a real social and personal problem, but it is obviously not the fate of the majority of women who end up on welfare. Using the welfare system as a short-term crutch is also a type of dependency if other options are available. But whatever the corrupting influence of welfare, it seems to have reached a certain plateau. This does not, however, diminish the imperative to assess its good and bad effects on those who depend on it, including the role of work in their lives, and its costs and benefits to society.

The Economics of Welfare

There are two related but distinct problems in attempting to bring welfare under control. One is to improve the earnings of recipients so that welfare is no longer necessary or even attractive. The other is to decrease caseloads and expenditures. It is a mistake to assume that a strategy attacking the first problem will necessarily solve the second in the short term, or vice versa.

The view that welfare is an alternative to work is insufficient to understand the dynamics of welfare dependency in the aggregate. Clearly, the willingness of a person to work is affected by the relationship between his earnings potential and the level of welfare benefits. But the relationship is not a simple equation. If leisure has some positive value in and of itself, potential earnings would have to be higher than welfare to induce someone to work. If work has a high intrinsic value, then clearly some low-income people will prefer working to being on welfare even if they are worse off financially. And in practice, of course, most people do not have a "free" choice between welfare and earned income, because there are constraints on access to each and relative costs imposed by welfare and tax laws.

Thus, rational economic choices are made in the context of a value system and a legal-administrative system. It is not insignificant, considering the composition of the dependent population today, that AFDC was almost the only welfare program that imposed no work requirement for decades, and when it did, applied and enforced these requirements very incompletely and half-heartedly. This feature of AFDC could not help but affect family structure in the population it served. The potentially damaging effects of welfare on low-income families were recognized and discussed in the 1960s, as even a cursory survey of the literature will demonstrate. Elizabeth Durbin (1969, p. 16), for example, noted:

> [T]here is clearly some economic advantage for the group affected by the existence of welfare to maintain fairly loose ties between men and the women with children. The mothers can obtain a steady, if low, income from welfare, and the men have more flexibility to come and go, to work or not. . . . [I]t is not unreasonable to expect more informal relationships where unwed motherhood is one qualification for the receipt of welfare income.

Economic theory also explains why welfare caseloads may rise even as economic conditions improve. If welfare benefits keep up with expected remuneration from low-skilled jobs—and not only the AFDC benefit but also medical care, housing assistance, and other services must be considered—then life on welfare might be preferable to job-hunting, even in an improving economy, especially for women. Likewise, increases in the minimum wage might seem to enhance the earnings potential of low-wage workers, but by reducing the number of jobs below the minimum, such minimum-wage increases can also reduce employment among the lowest skilled and thus expand the pool of those for whom welfare becomes an option.

Further, if the labor market offers unskilled men insufficient earnings to compete with a mother's welfare benefits—and this can be the case even in low-benefit states—then the mother becomes the family's primary earner. This situation complicates the problem of reducing dependency on welfare. First, her opportunities in the labor market are usually those of a secondary wage-earner. And since the welfare department has assumed the role of dependable primary provider, men are encouraged to adopt a secondary role as well, which further loosens their ties to the labor market. The increasing prevalence of secondary-earner labor market characteristics among low-income men must unavoidably contribute to what some have called a lack of "marriageable" men in low-income communities.

The significance of these basic economic relationships to the twin problems of reducing caseloads and expenses and fostering individual self-sufficiency are greater than they might at first appear. The first result of any work requirement in a welfare program is that there will be a strong incentive for recipients to appear unemployable. If welfare were a rational choice for someone to begin with, then clearly work would not appear attractive without significant enhancement of labor market opportunities for the recipient. This increases the burden on welfare administrators, who must determine who is and is not employable, ensure compliance, assist in job searches, and provide job training. All these conditions raise the short-term costs of welfare, unless caseloads go down. But caseloads depend on the number of new entries as well as exits, and new applications may increase for several reasons. Ironically, an excellent record of job placement with liberal transition benefits may even induce more women in the eligible pool to seek welfare as a means of obtaining job training and placement services.

The underlying problem does not disappear, because the welfare system must deal with the results of family nonformation or dissolution even as it facilitates those results. At the same time, work requirements within the welfare system will not improve work incentives or opportunities for absent fathers, while attempting to transform mothers into primary earners.

The Recent History of Workfare and Work Requirements

The term workfare was first used by President Nixon in 1969, but he did not use it in its current sense of working for welfare benefits (Shipp 1982, p. 1). His use of the word was more in keeping with the Kennedy-Johnson goal of providing the poor with training, work incentives, and opportunity. Nixon's welfare reform proposal, the Family Assistance Plan, was a negative income tax that would have extended welfare to the working poor and two-parent families nationally. Congressional fears of the increased costs associated with an expanded recipient population and work disincentives caused the proposal to die.

The first AFDC work program, however, preceded this proposal by seven years. The 1962 Community Work and Training Program (CWTP) allowed states to require AFDC recipients to work off their benefits, but only 13 states chose to exercise this option, and authorization for the program expired in 1967. In 1967 the Work Incentive program (WIN) was established to provide welfare recipients with a financial incentive to work by "disregarding" a portion of earnings so as not to lose as much in benefits as they otherwise would have. The initial focus of the program was job training, but in 1971 the focus shifted to job searching and immediate employment. In the early 1970s California and Utah implemented workfare programs in the present sense of the word—programs in which some recipients were required to work so as to receive benefits. In the late 1970s several other states followed suit.

Despite a history of nearly two decades of work requirements and incentives in AFDC programs, AFDC cash expenditures increased elevenfold (fivefold in constant dollars), and the costs of related public assistance programs also grew rapidly (Rein 1982, p. 6). The number of AFDC recipients has more than tripled since 1960, from 3 million to over 10 million; in the early 1970s the numbers increased by a million a year. But even though the trend leveled after 1972, spending did not. It is frequently pointed out that total state-federal spending on AFDC amounts to "only" $16 billion, a mere drop in the ocean of total public expenditures. What is frequently forgotten is that total federal, state, and local expenditures on means-tested programs now amount to $134 billion annually, or nearly 4 percent of GNP (Burke 1985b, pp. 1–2). And being on AFDC automatically qualifies recipients for most other major means-tested programs, while certain other programs—services and job-training, for example—were supposed to solve the problem of poverty by eliminating the need for "the dole." In other words, they were also supposed to be targeted at the welfare-eligible population.

Why did the work strategies of the 1960s and 1970s not work? One can, of course, point to changing mores—skyrocketing divorce and illegitimacy rates, the counterculture values of the 1960s, and the decreased dependence of women on men. But these better explain expanding caseloads and burgeoning costs than they do the specific failures of work strategies. Mildred Rein (1982) has analyzed the dynamics of the failure of three different approaches—work through social services, through incentives, and through requirements. Her analysis makes it evident that blame can be laid primarily at the feet of lawmakers who wrote vague and conflicting goals into the laws, and of the welfare establishment for its self-interest and disdain for work strategies.

Social services were mandated by amendments to the Social Security Act in 1962 and 1967. The ostensible purpose of providing social services was to move AFDC recipients toward self-support and to strengthen the family, Rein notes. But the 1962 law failed to define or specify "services." This task was left to welfare professionals, and service categories came to include everything from child care and health care to such vague nostrums as "improved family functioning" and "maintaining social relationships." This was theoretically corrected by the 1967 amendments, but many of the services specified—homemaker services, legal services, consumer education, and such—had little bearing on improving employability. Worse, the amendments called for providing services not only to welfare clients but also to former and potential clients. The law obviously left much to the discretion of social workers, with little potential for monitoring or evaluation. And, in fact, most services were not work-related nor did they go to working or work-oriented AFDC mothers.

The laws proved a bonanza for the social service industry, resulting in what Rein termed the "services explosion." From 1967 to 1972 federal grants to states for social services rose from $282 million to $1.8 billion. Much of the increase was the result of contracting-out to private service providers. When in 1973 the federal government attempted to cap social service payments to states at $2.5 billion, and to target 90 percent of benefits to AFDC recipients, the welfare industry rose up in arms, and strong lobbying in Congress ended in defeat of the initiative. By 1980 only 18 percent of social service recipients were AFDC clients, and 46 percent were those eligible without regard to income. Could social services as a strategy to promote work ever succeed? According to Rein (1982, p. 44), the question "cannot be answered," because the strategy "never became a reality."

The WIN program begun in 1967 was based on the theory of economic rationalism. By and large, the effective tax rate on welfare recipients who wanted to go to work had been 100 percent—for every dollar earned an equivalent dollar was deducted from the grant. Thus the WIN program mandated that states disregard a portion of recipients' earnings to encourage them to go to work. This was the well-known 30-and-a-third rule—the first $30 plus one-third of the remainder of earned income was exempted in determining the welfare grant. But this scheme did not appreciably encourage work, primarily because welfare mothers appear to have behaved even more rationally than the economists expected. Some increases in work effort were noted, but mostly in low-benefit states.

Nationally, the proportion of employed AFDC heads, fluctuating in the 13–15 percent range through the 1970s, remained what it had been without incentives. Apparently, the incentives were not attractive enough to induce non-working recipients to seek employment. For those who did work, the incentives provided an opportunity to maximize welfare benefits and part-time earnings to a level that would have been hard to achieve had they left the rolls altogether; in addition, they would have had to give up additional leisure, which they probably preferred to spend with their children. Thus, WIN improved the income levels of many AFDC mothers, but failed as a route to self-sufficiency. To improve work effort, incentives would have to be dramatically increased, which would raise costs prohibitively and raise questions of equity vis-à-vis the independent working poor.

The third work strategy of the 1960s and 1970s was statutory work requirements. Work had been mandatory for fathers in the Unemployed Parent component of AFDC (AFDC-UP) since its inception in 1961. But the UP rolls were relatively small, and from the mid-1960s Congress was also concerned about work for AFDC mothers. In addition to the incentive component discussed above, the WIN program was also the first federal effort to require all employable welfare recipients to work or seek work. The funding for the program, however, was insufficient to train and employ even a small fraction of the adults on AFDC. Consequently, Congress specified guidelines that virtually exempted various classes of recipients from participation, and the states added still more qualifications. Since the states were not always able to provide the child care stipulated by law, and since social workers were allowed to assess the effects on a particular family's "well-being" before referring clients to WIN, the program became largely a voluntary one, a matter to be decided between client and caseworker. Moreover, according to several studies cited by Rein (1982, p. 69), the attitude of caseworkers toward work for AFDC mothers was basically negative. The requirement to seek work actively or enroll in training was not implemented as a matter of sound public policy to discourage dependency, but as yet another service to welfare recipients. A work requirement that does not actually require people to work is not likely to succeed either in decreasing caseloads or fostering self-sufficiency.

The two states which implemented workfare programs in the early 1970s—California and Utah—thus flew in the face of the prevailing sentiment of the welfare establishment. The California Community Work Experience Program (CWEP), enacted in 1971, stressed that the employment of welfare recipients was a major goal of welfare. This program has essentially provided the model for subsequent workfare proposals. Private-sector employment for job-ready recipients was stressed, with training to be provided for those less employable. Only if neither of these activities produced results was the recipient required to work off the welfare grant by working in a public service agency, including private nonprofit organizations. The maximum number of workfare hours per month was 80, and the recipient was expected to look for a private-sector job in his spare time.

The program is frequently cited as a failure, but the reasons for the failure are illuminating. The federal Department of Health and Human Services (HHS) opposed workfare and approved the California plan only reluctantly and after some delay. Moreover, it was opposed by liberals in the California legislature from the beginning. This initial resistance and a pending court case made many counties unwilling to implement the plan until well into its second year, and more than a third of California's counties never implemented it at all. According to Charles D. Hobbs, then chief deputy director of social welfare in California, an "attitude of polite disdain and inaction" in the legislature "filtered down through the ranks of employment and welfare workers" (see Germanis 1982, p. 8). The program failed because it was not implemented as conceived.

The Utah Work Experience and Training program (WEAT), established in 1974, was also initially resisted by HHS. The program requires employable recipients to work three days a week, with a 12-week limit on participation so that recipients do not develop a permanent dependence on workfare. State and local government administrators in Utah were strong supporters of workfare from the start, but even they only claimed that WEAT had a "general housecleaning effect" (Germanis 1982, p. 6)

As a method of eliminating some fraud and abuse, workfare obviously has some merit and is justifiable from the public point of view. But for those who really need welfare, the impact is unclear. There is always considerable turnover on the welfare rolls, because most recipients are short-term ones, so it is difficult to ascertain just how much workfare contributes to turnover. In Utah, for example, the average monthly caseload in FY 1984 was about 13,000, almost exactly the same as in FY 1978 (and about 1,000 higher than in FY 1975–77), and total payments to welfare clients rose from $41 million to $51 million. So even though there may still be valid reasons for implementing workfare, the evidence that it reduced costs to the state or reduced the dependency of the welfare-eligible population in Utah is shaky at best.

Workfare Today

The Omnibus Budget Reconciliation Act of 1981 (OBRA) effected some major changes in the AFDC program that laid the foundations for subsequent work-related reforms in various states. In addition to tightening up eligibility for welfare, which resulted in some caseload reduction, OBRA reduced the work incentives and made them short-term instead of ongoing. Just as the incentives were found not to have increased work effort among AFDC mothers in the aggregate, so their elimination did not appear to reduce effort, as several studies have noted.[2] The 1981 budget act also permitted states to establish workfare programs, called Community Work Experience Programs

---

[2] These are summarized in Institute for Research on Poverty, *Focus* 8 (Spring 1985): 1–5.

(CWEP), to make participating welfare recipients more employable. The workfare employment was to serve a "useful public purpose" but did not require public-sector employment. In addition, states were permitted to set up WIN demonstration projects for three years ("WIN demos") in lieu of the existing WIN program. The CWEP programs and the WIN demos comprise the bulk of ongoing workfare and work-related welfare reform experiments in the country today. Currently, 37 states are experimenting with such programs, though fewer than 10 on a statewide basis.

Although it is too early to predict either success or failure for any of these programs or whether the results will differ appreciably from what occurred in the 1960s and 1970s, available reports and evaluations allow us to make some tentative comparisons and observations:

1. The political climate appears to have shifted strongly in favor of work strategies in welfare, and there is increasing acceptance in the welfare establishment of the value of work in promoting independence. This shift in social attitudes is also reflected in public opinion polls, which show that about 90 percent of the American public supports work and job training components in welfare.[3]

2. The distinction between "punitive" workfare and other work-related programs and between voluntary and mandatory work is more illusory than real. Although much of the national political debate is still couched in those terms, in practice, economic and social constraints restrict what states can do; program design and implementation reflect this fact. West Virginia, for example, runs a straight workfare program with mandatory participation for all but women with children under six. Benefits are worked off at minimum-wage rates for as long as a recipient is on welfare. The Massachusetts program, which is entirely voluntary, provides job search, training and placement services with child care, and transportation and medical coverage into the first year of private-sector work. But the state's job placement method does not differ appreciably from the job search preceding traditional workfare programs, and participation in the program is actively encouraged if low-key. However, states with mandatory workfare programs provide numerous exceptions and do not always have the capacity to provide and supervise work for all eligibles.

3. On the whole, welfare recipients themselves do not seem to view work requirements as either unfair or punitive, and in some

---

[3] For example, a Sindlinger Poll commissioned by the Heritage Foundation in 1985 found 94 percent of Americans supported the principle of working off welfare benefits. Other national polls show 88 to 93 percent support.

cases work provides a source of pride. The Manpower Demonstration Research Corporation (MDRC), which studied welfare employment initiatives in 11 states over a five-year period, found "quite similar" results at various worksites throughout the country: even in jobs that required relatively few skills, there were "high levels of job satisfaction, and an acknowledgment that a requirement to work for one's welfare check is a fair principle" (Ball et al. 1984, p. xvii). Participants interviewed in Arkansas "said that they liked their jobs, believed they had learned something, and stated that they felt better about getting welfare when they were working for it" (Friedlander et al. 1985, p. xvii). In view of the recent history of work strategies and caseworker resistance to them, the following comment on workfare implementation in Virginia is both illuminating and heartening: "Because of a lack of consensus on the general value of work experience, staff initially treated the component as voluntary. As staff found that registrants liked the component, however, they became more comfortable using it" (Price 1985, p. xxi).

4. There is little hard data on the cost effectiveness of work-for-welfare, or on its impact on caseload reduction. Such data as do exist—and MDRC provides some of the most reliable to date, given the difficulties of quantifying some of the factors—will provide both opponents and supporters of workfare with ammunition, since the glass is both half-full and half-empty. One typical MDRC finding, for example, showed that 61 percent of the experimental group in San Diego obtained private-sector jobs over an 18-month period, compared to 55.4 percent of the control group. An improvement, certainly, and important to the individuals involved, but hardly a cause of joy for those who expect a significant budgetary impact. The more so because "savings" in studies of this kind deduct the monetary value of "social benefits" from expenditures, which does not necessarily reflect a reduction in expenditure levels.

Cost reduction "success" in programs without control groups is even more difficult to measure and depends very much on how the evaluator chooses to define it. Such evaluations can range from the modest conclusion in a report on the Ohio work programs, that "the resultant welfare savings are substantially less than program costs," to claims by Massachusetts officials that their much more ambitious program "saves" the state $22 million a year in welfare costs (Potomac Institute 1985, p. i.; Overbea 1985).

In fact, the Massachusetts program is probably no more nor less successful than other work-for-welfare designs, but it still awaits a serious study. Meanwhile, the facts are these: the state's Employment Training Choices Program (ET) has placed over 18,000 welfare recipients in jobs in two years of operation (Overbea 1985). Critics have pointed out that Massachusetts has a very low unemployment rate and wonder whether such figures could be duplicated elsewhere. But a more salient question is whether that is such a notable achievement at all. According to a Massachusetts Department of Public Welfare (1985) report, more than half of the state's AFDC families stay on welfare less than a year. The report also states that the number of welfare recipients who are not in the ET program and who find jobs through other means is the same as the number who find jobs through ET. Further, since there is no control group, it cannot be determined how many of the 18,000 would have found jobs in any case. It is also not clear how competition in the job market by some AFDC recipients through ET initiatives affects other job seekers who are potential AFDC clients. There seem to be as many new case openings as closings. When the ET program began in October 1983, the welfare caseload was 89,700; in September 1985, it was 88,800. Over the two-year period, the monthly caseload did drop to as low as 84,600 but also has risen to as high as 89,000. The caseload varies by several thousand from month to month, but the trend is level.[4] And this is in spite of Massachusetts' low unemployment rate.

By contrast, the caseload in Massachusetts during the two-year period before adopting ET had decreased by about 25 percent. Moreover, each ET job placement thus far has cost Massachusetts about $3,000 and costs are projected to rise, primarily because of the day care component. The state's per-placement costs in the WIN program from 1978 to 1981 averaged $900.[5] The Massachusetts experience illustrates perfectly the continuing tension between the two very different goals of work programs: reducing caseloads versus providing a service for welfare recipients.

The Case for Workfare

The case for workfare cannot really be made on cost-saving grounds, at least in the short run. Depending on the design and goals of the program, it can be either more or less expensive than welfare without work requirements. But there are obvious though unquantifiable social benefits in establishing a system wherein reciprocal obligations and mutual respect are the basis for the interaction of welfare recipients and society.

---

[4] Data from the Office of Family Assistance, Social Security Administration, U.S. Department of Health and Human Services.

[5] Ibid.

Dependency can certainly be exacerbated by a lack of commitment to the work ethic, but work requirements in welfare programs or the lack of them are only a small part of the total picture, as de Tocqueville once observed. Just as then, work requirements today will not provide a panacea for dependency. Workfare in the 1980s has a better chance for success than it did in the 1960s and 1970s, but only if we learn to be happy with marginal successes. And we must be realistic about the ability of any welfare reform to solve the intrinsic problems of income transfer disincentives.

History shows, however, that some economic inefficiency is a price our wealthy society may be willing to pay to assist the needy. But we should be quite clear about the difference between doing something to the poor for our own benefit—whether we are social workers or taxpayers—and actually doing something *for* the poor.

References

Auspos, Patricia. *Interim Findings from a Grant Diversion Program, Maine.* New York: Manpower Demonstration Research Corporation, June 1985.

Ball, Joseph et al. *Interim Findings on the Community Work Experience Demonstrations, West Virginia.* New York: Manpower Demonstration Research Corporation, November 1984.

Burke, Vee. "The History of American Social Welfare Policy." National Forum Foundation *Policy Forum* 2 (February 1985a).

Burke, Vee, comp. *Cash and Noncash Benefits for Persons with Limited Income: Eligibility Rules, Recipient and Expenditure Data, FY 1982–84.* Congressional Research Service Report No. 85-194 EPW. Washington, D.C.: CRS, updated 30 September 1985b.

California. Legislative Analyst. "Job Search, Training and Work Experience: The Lessons for California from Eight Evaluations of the Work Incentive Program." Sacramento, Calif., January 1985. Typescript.

Decision/Making/Information. *Nationwide Survey on Women's Issues.* McLean, Va., 1983.

de Tocqueville, Alexis. "Memoir on Pauperism." Reprinted in *The Public Interest* 70 (Winter 1983): 102–20. (From *Tocqueville and Beaumont on Social Reform.* Edited and trans. by Seymour Drescher. New York: Harper Torchbooks, 1968.)

Durbin, Elizabeth. *Welfare Income and Employment: An Economic Analysis of Family Choice.* New York: Praeger, 1969.

Friedlander, Daniel et al. *Final Report on the WORK Program in Two Counties, Arkansas.* New York: Manpower Demonstration Research Corporation, September 1985.

Germanis, Peter. "Workfare: Breaking the Poverty Cycle." Heritage Foundation Backgrounder no. 195. Washington, D.C., 9 July 1982.

Goldman, Barbara et al. *Findings from the San Diego Job Search and Work Experience Demonstration, California.* New York: Manpower Demonstration Research Corporation, March 1985.

Hobbs, Charles D. *The Welfare Industry*. Washington, D.C.: Heritage Foundation, 1978.

Institute for Research on Poverty (Madison, Wis.). "Measuring the Effects of the Reagan Welfare Changes on the Work Effort and Well-Being of Single Parents." *Focus* 8 (Spring 1985): 1–5.

Massachusetts Department of Public Welfare. *The Facts about Welfare: Being Poor in Massachusetts*. Boston, July 1985.

Overbea, Luix. "Bay State's New Work Program Moves Thousands Off Welfare." *Christian Science Monitor* (18 September 1985).

Price, Marilyn. *Interim Findings from the Virginia Employment Services Program*. New York: Manpower Demonstration Research Corporation, May 1985.

Potomac Institute for Economic Research. *The Ohio Work Programs: Assessing the First Two Years*. Washington, D.C., October 1985.

Quint, Janet et al. *Findings from the Maryland Employment Initiatives Programs*. New York: Manpower Demonstration Research Corporation, February 1984.

Rein, Mildred. *Dilemmas of Welfare Policy, Why Work Strategies Haven't Worked*. New York: Praeger, 1982.

Sherwood, Kay E. *Preliminary Management Lessons from the WIN Demonstration Program, Arizona*. New York: Manpower Demonstration Research Corporation, November 1984.

Shipp, P. Royal. *Workfare in AFDC and Food Stamps*. Congressional Research Service Issue Brief No. IB81149. Washington, D.C.: CRS, updated 22 November 1982.

U.S. General Accounting Office. *Evidence Is Insufficient to Support the Administration's Proposed Changes to AFDC Work Programs*. GAO/HRD 85–92. Washington, D.C.: Government Printing Office, 27 August 1985.

WELFARE AND WORK: MICROECONOMIC VS. MACROECONOMIC CONSIDERATIONS

William A. Darity, Jr. and Samuel L. Myers, Jr.

Anna Kondratas (1986) provides a balanced and pragmatic assessment of the likely short-run advantages and disadvantages of incremental changes in welfare rules and requirements. The specific changes to which the essay refers are changes in work requirements. Two sections of the paper admirably summarize the history of workfare and the preliminary insights learned from attempts to implement workfare in several states. But the main thrust of the paper goes to the core of the debate on the benefits and costs of *any* incremental changes to welfare in America.

By incremental change, we mean the sort of marginal tinkering with welfare rules, eligibility requirements, work requirements, or benefit formulae that leaves largely unchanged the functional role of the public welfare system. The marginal tinkering can and often does produce results that must be evaluated with the fine lens of the microeconomist. That explains the proliferation of such terminology as "incentives," "disincentives," and "rational choice" among analysts in this area.

The bigger picture—the picture that portrays the complex and frequently contradictory functions of public welfare in a democratic society—is often obscured when one narrows the focus to the behavior of welfare recipients. Indeed, the microbehavior of other important actors in the big picture might be inadvertently overlooked when one contrains the analysis to, say, unwed teenage mothers. For example, conventional studies, such as those using the National Survey

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

William A. Darity, Jr. is Associate Professor of Economics at the University of North Carolina, Chapel Hill, and Samuel L. Myers, Jr. is Professor of Economics and Director of Afro-American Studies at the University of Maryland, College Park.

of Family Growth to investigate the use of contraceptives by youth, are structured to answer these questions: Why do black females not make effective use of birth-control pills, and why do black females begin sexual activity at such an early age? But these questions cannot inform us about why black males do not use prophylactics or why black males do not take responsibility for the outcomes of their sexual adventures. In the absence of hard evidence to inform answers to these questions, anecdotes and conjectures prevail over facts and truth.

While it is obvious that it takes men and women to create babies born out of wedlock, what is less obvious when one examines the microlevel evidence is why we know so little about the fathers of these unwanted births. Although it is obvious that AFDC is largely a program for mothers and their children, it is less obvious why we know so little about the work behavior, the labor force participation, the legitimate and illegitimate earnings, and the multiple program participation of the men in the lives of those families. In other words, why is our informational base for decision making so constrained?

Some of the conjectures that Kondratas raises about the work disincentives of welfare and the effects of workfare can be faulted for relying too heavily on a meager informational base. For example, she suggests most men will withdraw from the labor market when the female's welfare benefits increase. But this hypothesis cannot be tested adequately using cross-sectional data like the Current Population Survey (CPS); and in panels, like the Panel Study of Income Dynamics (PSID), black males disproportionately drop out of the sample. Other comments are more speculation than fact. For example, she contends that marital behavior and welfare participation are a response to rational choices. In a recent paper (Darity and Myers 1984) we find such demographic variables as the sex-ratio, not welfare attractiveness, explain the rise in female-headed families among blacks.

Since most of this speculation and conjecture is balanced with the appropriate caveats and caution, and since there are major insights that can help us visualize the bigger picture, the following comments are limited to an elaboration of a brilliant, although unexploited, thesis embedded in Kondratas's paper. This insight concerns the role of welfare managers in the current welfare crisis. It is useful, however, to begin by sketching out the micro- versus macro-economic interpretation of the relationship between work and welfare.

Welfare Growth and Labor Force Withdrawal

The first version of the big picture is grounded in the neoclassical microeconomic wisdom of rational choice: increases in welfare attractiveness induce the withdrawal from the labor market of the least productive workers. In the telling of this story, Richard Butler and James Heckman (1977) contend that the self-selection effect is particularly pronounced among blacks and thus contributes to the illusion of significant earnings gains for blacks relative to whites during the post–civil rights era. The support that Richard Freeman (1973) and others have found for the effectiveness of Affirmative Action policies in reducing earnings inequality is therefore soundly challenged. Butler and Heckman conclude that government transfer programs have hurt rather than helped the prospects of moving the poor into the mainstream of the work force.

Unemployment and Welfare Growth

A second version of the big picture is that welfare is used as a labor market regulatory device. When the pool of surplus labor grows, welfare loads grow in order to dampen the potential political repercussions of masses of idle workers. When the pool declines, or when labor shortages develop, real welfare benefits fall and welfare rolls are reduced to keep private sector wages low and to replenish supply. The best-known rendition of this story is found in Piven and Cloward (1971), although other variants point to similar conclusions (Roberts 1985; Katz 1985).

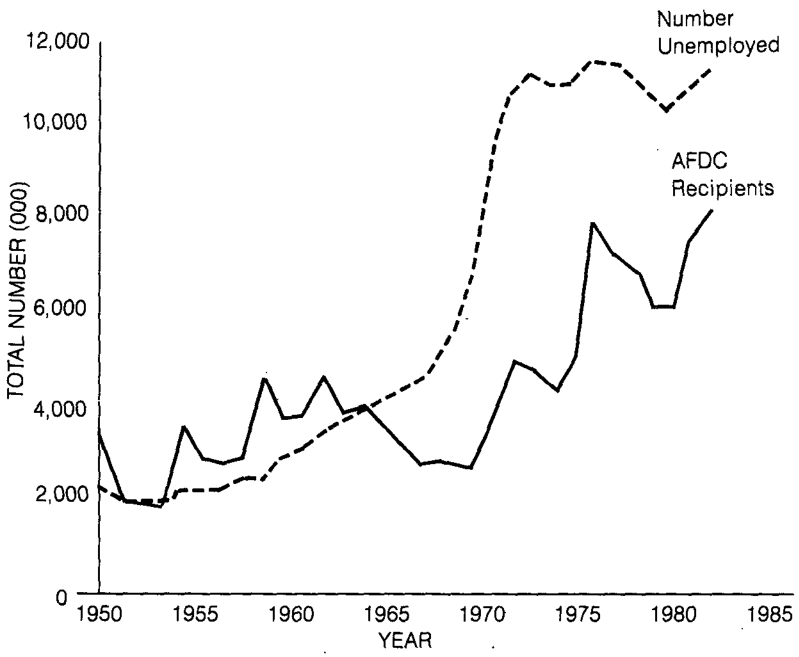
Both stories predict explicit relationships between aggregate levels of unemployment and welfare. The microeconomic version predicts an inverse relationship. As welfare benefits rise (perhaps due to improved economic conditions) those with the highest levels of unemployment withdraw from the market in favor of welfare: Welfare grows but unemployment declines. The macroeconomic version suggests the opposite. When unemployment increases, welfare should increase; when it falls, so too must welfare.

A look at Figures 1 and 2 reveals limited support for the selective withdrawal hypotheses during the 1960s and early 1970s. During a decade when unemployment dropped from 6.7 percent in 1961 to 3.5 percent in 1969, welfare grew from 1.96 percent of the population to 3.6 percent, or from 3.5 million to 7.3 million people.

After 1972 or so, however, the pattern changed. Welfare totals and rates move more closely with unemployment. In recent years, the regulatory role of welfare seems to be at work. The macroeconomic picture seems more appropriate for describing recent trends than does the microeconomic perspective.

FIGURE 1

NUMBER OF AFDC RECIPIENTS AND UNEMPLOYED PERSONS, 1950–81

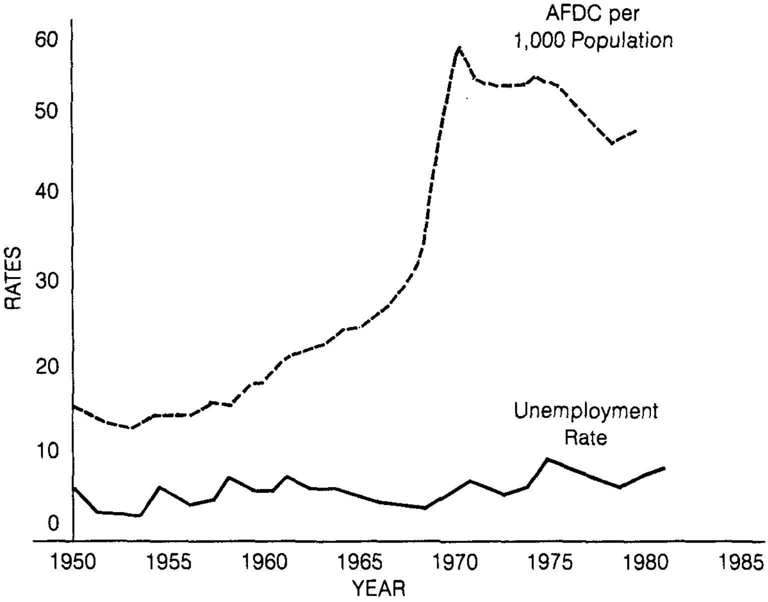


Managing Welfare

For welfare to serve a labor market regulatory role, however, there must be regulators. And here is where Kondratas's paper is so illuminating. We see a clear example of a bureaucratic and administrative apparatus that grows and grows and becomes an independent managing agency for the poor. Welfare administrators' interests, as Kondratas suggests, play as important a role in determining welfare outcomes as the behaviors, rational or not, of their clients.

In several of our recent papers (Darity and Myers 1983, 1984a, 1984b) and in our forthcoming book we contend that the welfare crisis and the rise in black female-headed families are statistically correlated with the expansion of welfare benefits, but not for the reasons that Charles Murray (1984) and others have suggested. Rather, the direction of causation is the other way around. The growth in size and composition of the welfare eligible population has influenced changes in welfare administrative parameters. These changes, in turn, have had little to do with the "welfare" of the poor, because

FIGURE 2
AFDC PARTICIPATION RATE AND UNEMPLOYMENT, 1950–81



the newly emerging managerial class that oversees the welfare bureaucracy—increasingly black and female—has ambiguous and often conflicting motives toward the poor.

For example, the most significant employment gains for black female professional workers in the 1970s were in the industry classification, public administration, which includes state and local government, federal agencies, and yes, welfare offices (Malveaux 1985). These gains can either be protected by maintaining the size of the welfare pool or by more efficiently moving clients on and off the rolls. Indeed, one interpretation of findings that demonstrate a decline in long-term dependency is that turnover rates in recent years have increased. In other words, the size of the welfare pool can be maintained by welfare managers even as there is a drastic shift in its composition.

The future task of political economy of welfare is to unravel these contradictory and complementary motives of welfare regulators. Viewing them as a special interest group, a managerial elite, or as a class whose interests are misaligned with their clients' may prove a useful function in helping to understand the larger phenomenon of the regulatory role of the state.

References

Butler, Richard, and Heckman, James J. "The Impact of the Government on the Labor Market Status of Black Americans." Paper presented at the Industrial Relations and Research Association conference on Equal Rights and Industrial Relations, Madison, Wis., 1977.

Darity, William A., Jr., and Myers, Samuel L., Jr. "Changes in Black Family Structure: Implications for Welfare Dependency." *American Economic Review* 73 (May 1983): 59–64.

Darity, William A., Jr., and Myers, Samuel L., Jr. "Does Welfare Cause Female Headship? The Case of the Black Family." *Journal of Marriage and the Family* 46 (November 1984): 765–79.

Darity, William A., Jr., and Myers, Samuel L., Jr. "Public Policy and the Condition of Black Family Life." *Review of Black Political Economy* 13 (Summer/Fall 1984): 165–87.

Darity, William A., Jr., and Myers, Samuel L., Jr. *Social Policy and the Black Family*. Forthcoming.

Freeman, Richard. "Changes in the Labor Market for Black Americans." *Brookings Papers on Economic Activity* 1 (1973): 67–132.

Katz, Michael B. "What's Compassion Got to Do with Welfare?" Letters. *New York Times*, 1 November 1985.

Kondratas, S. Anna. "The Political Economy of Work-for-Welfare." *Cato Journal* 6 (Spring/Summer 1986): 229–43.

Malveaux, Julianne. "The Economic Interests of Black and White Women: Are They Similar?" *Review of Black Political Economy* 14 (Summer 1985): 5–27.

Murray, Charles. *Losing Ground*. New York: Basic Books, 1984.

Piven, Frances F., and Cloward, Robert A. *Regulating the Poor*. New York: Pantheon, 1971.

Roberts, Russell. "Workfare Doesn't Work." Op-ed. *New York Times*, 10 October 1985.

FARM COMMODITY PROGRAMS AS INCOME TRANSFERS

Bruce Gardner

Farmers have substantial political clout. We have two kinds of evidence for this. One is that elected officials are united in praising the farmer and things rural generally. You will not find, in politicians' statements about farming and farmers, the quasi-ideological divisions that pervade political discussions of labor unions, chemical companies, and sanctions against South Africa. The second, more powerful evidence is the money spent to support farmers' incomes. This paper examines the transfers to agriculture in the 1980s and attempts to explain why they occur.

Income Transfers to Agriculture

Data on federal agricultural expenditures are shown in Table 1. The agricultural economy at the end of the 1970s was in reasonably good shape, although some commodity markets had weakened considerably since the 1973–75 boom in prices. When the Agriculture and Food Act of 1981 was passed, its anticipated budgetary costs were $1–2 billion. As commodity markets weakened, however, program costs soared. The $9 billion spent on Commodity Credit Corporation (CCC) stock acquisitions in 1982 was especially alarming because the prospective market for these commodities was weak, and 1983 promised further surpluses. Consequently, the Payment-in-Kind (PIK) program was introduced in 1983. This program paid farmers up to 80 percent of the gross value of output they could have produced in return for holding their land idle. The payment was in the form of CCC commodities—for example, if a farmer's established

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Professor of Agricultural and Resource Economics at the University of Maryland and a former Senior Staff Economist for Agricultural Policy for the President's Council of Economic Advisers.

TABLE 1

FEDERAL OUTLAYS ON FARM PROGRAMS
(IN MILLIONS OF DOLLARS)

	Calendar Year					
	1979	1980	1981	1982	1983	1984
Deficiency Payments						
Wheat	36	0	393	633	618	1,202
Rice	58	0	0	156	260	171
Feed Grains	290	65	45	529	461	296
Cotton	0	0	0	683	588	250
Subtotal	384	65	538	2,001	1,927	1,919
Diversion Payments[a]	150	3	0	139	6,390	5,718
Disaster Payments	318	699	652	182	75	1
Wool, Conservation, and Grain Storage Payments	565	518	841	1,169	902	807
CCC Dairy Purchases	1,008	1,519	2,182	2,562	2,611	1,521
CCC Commodity Loan Costs	−885	451	2,034	9,082	−749	−816
Total	1,539	3,256	6,148	15,136	10,264	9,150

[a] Includes Payment-in-Kind (PIK) commodities.

SOURCE: Department of Agriculture, *Economic Indicators of the Farm Sector* (annual editions).

yield were 100 bushels per acre, he would receive 80 bushels per acre in the PIK program. This was an attractive offer and 77 million acres—about a fifth of U.S. cropland—was idled. PIK involved an even more massive effort to control production than had occurred in the 1930s and 1950s. Farmers benefited both from PIK payments and higher prices on their output. Although it is difficult to separate the effects of PIK from the effects of the 1983 drought, it was estimated that PIK caused about a 20 percent price increase, generating a $10 billion gain to producers (Gardner 1984).

The sugar program does not involve substantial budget outlays but nonetheless makes producers better off by driving up market prices. This is readily accomplished for sugar, because up to the 1980s about half of U.S. sugar consumed was imported. Therefore, import controls could raise the U.S. price as desired. By the summer of 1985 the New

York landed price was 21 cents per pound while the New York offshore (world market) price was 3 cents per pound. This level of support was sufficient to maintain a new industry of high-fructose corn syrup (HFCS) as a substitute for sugar. With costs estimated at 8 to 16 cents per pound, HFCS could not exist in competition with sugar at world market prices. The costs of the sugar program to consumers amount to about $3 billion per year (Ferguson 1985). Taxpayers could regain part of this sum if the program restricted imports by means of a tariff. But the restrictions have taken the form mostly (and now solely) of import quotas. Moreover, these quotas are not sold or given to domestic sugar importers but are allocated free of charge to exporting countries. Therefore, exporters reap the quota rents, which are worth several hundred million dollars per annum.

The tobacco and peanut programs also do not involve substantial budget outlays, but rely on production/marketing quotas to restrict output and drive up prices. These commodities are heavily exported, and the demand for them has been quite elastic. In tobacco the export market has been considerably eroded in the past decade, so that substantial quota reductions have been necessary (Sumner and Alston 1984). The cost to consumers of these programs is about $1 billion.

In addition to the budgetary and consumer costs of the farm programs, the Department of Agriculture spends considerable resources to administer the programs. The administrative agency, the Agricultural Stabilization and Conservation Service, has 3,000 full-time and 13,000 part-time employees, offices in some 3,000 counties, and a $400 million annual budget.

A full assessment of the costs of farm programs to U.S. consumers and taxpayers requires an estimate of what all commodity prices and outputs would be in the absence of the commodity programs. Judgments about this counterfactual situation are so conjectural that any overall estimate cannot be held with much confidence, although plausible orders of magnitude are easy to obtain using budgetary outlays, support prices, and estimates of supply and demand elasticities found in the literature. One overall estimate is that for 1985, there was a $19 billion loss to consumers and taxpayers from the grain, rice, cotton, tobacco, peanut, wool, and dairy programs (Gardner 1985).

The gains to producers are more difficult to estimate. Producer gains are necessarily smaller than consumer and taxpayer losses for several reasons: (1) producers must hold land idle in order to receive program benefits, thereby forgoing the rental returns that could have been earned on that land; (2) taxpayers spend money to store commodities that will never be resold at their acquisition and storage costs; (3) funds spent on administration do not accrue to producers; and (4) since producers and consumers face different prices for the same commodity, and relative prices for different commodities are distorted from unrestricted market equilibrium values, there are efficiency losses in resource allocation. Using the same supply and demand parameters and program assumptions that generated the $19 billion in consumer and taxpayer costs, I estimated a $14 billion net gain in producers' surplus. The overall deadweight loss to the United States is therefore estimated at $5 billion per annum, or about 6 percent of GNP originating in agriculture.

The producer gains as estimated are overstated. They are based on supply and demand elasticities for short-term (annual) price changes. Long-run elasticities are more pertinent to simulation of a market-oriented policy regime that permanently replaces current programs. The distinction between short-run and long-run elasticities has been found particularly important in empirical studies of supply responses. The interpretation of short-run and long-run losses to producers is that in the short-run producers forgo quasi-rents, as well as write-offs on investment in capital equipment and perhaps human capital. In the long run, however, capital is invested at the economy-wide rate of return, so there are no long-run losses to farmers from eliminating the commodity programs (and no long-run benefits from keeping them). Empirical evidence developed by Phipps (1985) shows that the rate of return on investment in agriculture has not been affected by post–World War II farm programs.

Even using long-run elasticities, U.S. farm programs at 1985 levels generate an $8–10 billion increase in producers' rents (Gardner 1985). Evidence on long-run factor supply functions in agriculture is insufficient to determine which inputs earn these rents. The usual presumption among agricultural economists is that the rents must accrue predominantly to land, because in agriculture no other factor of production is plausible as a specific factor in the long run (see Gertel 1985).

With long-standing programs it is necessary to identify landowners by date of acquisition of their land, since purchasers of land that already has a stream of anticipated program-created rents attached to it will have to pay for the rents. We should expect, however, that current purchasers would not pay the discounted present value of current program rents extended in perpetuity. There will be some expectations that the program will end or depreciate in value (although the program also could increase in value). If each year the program has a non-zero probability of ending, then that probability will be reflected in the value of land. And if the program in fact continues, the purchaser will have received a windfall gain. He will have had income at a rate higher than the normal rate of return, without the capital loss that ending the program would have caused.

The flue-cured tobacco program provides a good example of program rents because it operates by issuing farmers marketing rights ("quota") that can, within geographical limits, be rented on an annual basis as well as bought and sold with land. Sumner and Alston (1984) estimate that in 1984 North Carolina's tobacco quota had an average rental value of about 45 cents per pound. They cite evidence that at this same time tobacco quota sold for $1.35 to $1.80 per pound, or 3 to 5 times its rental value. Using the mean of 4 times, these figures indicate that quota (with or without land) could be purchased and rented for a 25 percent annual rate of return. Given a 10 percent economy-wide rate of return, the expected rate of depreciation of tobacco quota value would be about 15 percent. This sort of calculation is important in designing a policy reform that avoids windfall losses. A program that gradually reduced the value of tobacco quota by 15 percent per year would, in this example, provide the economy-wide average rate of return to quota owners.

A long-standing program, moreover, will gradually transfer original rent-earning assets to former farmers, retired farmers, or their descendants. Sumner and Alston (1984) estimated that by 1981 only 24 percent of the flue-cured tobacco quota was owned by the tobacco farmers. Hence, the effect of farm programs on income distribution can be quite different from what might be inferred from examining the population of farm operators.

The Food Security Act of 1985 establishes the main features of the farm commodity programs for the next five years. Many interest groups that were harmed or not helped by the 1981 act tried to influence the 1985 legislation. The 1985 reform movement was given a substantial boost by the 1983 PIK program, the largest acreage-idling program ever. The PIK program imposed losses on some input suppliers whose business declined, penalized livestock producers who had to pay more for feed, and harmed marketing firms who had fewer products to handle. Many from these industries wanted a 1985 act that would be "market-oriented" in eschewing future massive production control programs. A wide range of academic and other so-called disinterested observers were recommending quite thoroughgoing market orientation, with cuts in target prices (producer price guarantees achieved by "deficiency" payments) and loan prices (support levels achieved by CCC acquisition of commodities). This approach was recommended by the Reagan administration and was consistent with a general thrust toward less governmental intervention in the economy.

In the end, the 1985 act achieved one important objective, lowering commodity loan prices. However, target prices remained frozen and acreage-idling machinery remained in place. Hence, producer incentive prices and income redistribution to producers were essentially unchanged. Lower loan prices meant that CCC stocks would fall, or at least accumulate less rapidly. Consumer prices in the United States and world prices of supported commodities would also fall, perhaps by as much as 20 percent for grains, a prospect not welcomed abroad. Federal budgetary costs promise to rise from about $12 billion per year in 1982–85 to $20 billion in 1986–88, because the gap between target prices and market prices will increase. Essentially this means that some redistribution from domestic and foreign commodity users to U.S. farmers now will be replaced by transfers from U.S. taxpayers to farmers.

There is much scope for debate on both general and specific elements of estimated income transfers to U.S. agriculture. It has even been argued that farmers have not benefited at all in the long run because program-generated overproduction, inefficiencies in resource allocation, loss of foreign markets due to overpricing U.S. commodities, and the diversion of farmers, managerial skills, and effort into "farming the programs" have resulted in costs that outweigh the apparent gains from government payments and higher market prices.[1] This view can be taken as an instance of the Posner-Tullock idea that the resource costs of monopoly or an income transfer program equal the monopoly rents or income transfer.

Consider the dairy program. It should be considered a success story in that support prices increased in the 1960s when support prices for other commodities were declining in real terms. By the 1980s, however, repeated annual acquisition of about 10 percent of U.S. milk output, in the form of butter, cheese, and powdered milk, led to a situation in which the program's costs outweighed the political influence of dairymen. While target prices for grains have been increased in the 1980s, the milk support price has been cut from $13.10 per hundredweight to $11.60, with further cuts scheduled in 1986 and 1987. This backtracking does not mean that the dairy program was an economic mistake on the part of dairy producers, or even overreaching based on their political influence. Long-run elasticities of supply and demand are greater than short- and intermediate-run elasticities, so it may have been optimal from the viewpoint of producers to boost support prices substantially for a few years, then scale them back as longer-term supply responses were forthcoming. In short, current problems in the commodity programs do not mean that farmers should regret their past political successes, or that the producers who lobbied for them did not gain real wealth as a result.

---

[1] See, for example, the "Joint Statement on Agricultural Policy by former Secretaries of Agriculture Freeman, Hardin, Butz, and Bergland" (Department of Agriculture, July 1985).

Why Income is Transferred to Agriculture

A natural starting point in the consideration of income transfers to the agricultural sector is to suppose that protective economic regulation is chiefly the result of the industry's political pursuit of its economic interests. However, there are several reasons for considering alternative possibilities, including evidence of belief in market failure in agriculture, and the political realities of farm numbers.

Non-farmers might acquiesce in farm programs because they see the programs as guarantor of food availability and reliable prices—the idea of farm programs as consumers' insurance or stabilization programs. Unstable prices with risk averse consumers and producers can be viewed as a market failure that farm programs can rectify to the benefit of the economy as a whole. Programs aimed at curing instability are often difficult to distinguish from price support programs. The former seek to reduce the occurrences of either high or low prices (in relation to trend), while the latter seek only to reduce the occurrences of low prices. So merely observing attempts to prop up low prices is insufficient to sustain a judgment on the type of program we are observing. This ambiguity exists even if a floor price and no ceiling price is specified. Buffer stock rules for stabilizing prices often are specified in terms of both acquisition (floor) prices and release (ceiling) prices, but neither is necessary. What is necessary is that over time the program involves selling back on the market the quantity taken off the market to support the price. Any policy that over time places as much produce on the market as it removes from the market will to a first approximation have no effect on the mean price.

The evidence against U.S. farm policy being aimed at stabilization as opposed to support is that programs centered on buffer stocks have proved to be either unviable, as in the case of the 1929 Federal Farm Board, or have been modified to prevent stocks from re-entering the market and thus converted to a price support program. For example, in the 1950s the United States developed the P. L. 480 program to dispose of surplus stocks abroad. In the late 1970s the Farmer-Owner Reserve Program, initiated in 1977 as the purest stabilization program since the Federal Farm Board, was converted to a price support program by raising its entry price well above the CCC loan rate and by supplementing it with acreage controls. Even more telling politically was the reaction to the extraordinarily high prices of the mid-1970s. Brief attempts to hold farm prices down via beef price ceilings and export limitations in 1973–75 earned such opprobrium that candidates for office ever since have been virtually unanimous in promising never to attempt such a thing again.

Another purported form of market failure is the monopoly or monopsony power of nonfarm industry and of agricultural middlemen, processors, retailers, and input suppliers. Farm price supports could be thought a second-best policy given such distortions. However, the fact that the farm programs rely so heavily on production controls is inconsistent with the usual type of second-best argument. Monopolistic and monopsonistic exploitation result in too little farm output—monopolists sell less and monopsonists buy less than would occur in a competitive industry. Therefore, production controls magnify the distortion rather then counteract it. Still, farmers could support commodity programs simply as income distributional measures.

In the past, specific U.S. policies could be seen as directed against middlemen. The ban of trading agricultural commodity options in 1936, the abolition of futures markets in onions and potatoes, the taxation of emerging supermarket chains in the 1930s, the regulation of rail freight rates, the Agricultural Marketing Agreement Act of 1937—all these policy measures undoubtedly had complex origins, but an evident source of support for them was a belief that they would weaken farmers' powerful economic adversaries and hence aid farmers. Again, however, the notion of farm policy as a correction for market failure is not convincing. In recent years there has been little such legislation, and harassment, such as the ban on option trading, has ceased, in part in response to testimony that middlemen in agriculture by and large provide socially useful services and are more nearly competitive than monopolistic industries.

Assuming that farm policy is in fact aimed principally at supporting farm incomes, the question of why these policies are successful politically is even more difficult. After all, the farm population of 5.4 million (Bureau of the Census estimate for 1984, down 7 percent from 1983) is less than 3 percent of the U.S. population. Even if we include 2 million farm laborers, most of whom obtain by far the majority of their incomes from nonagricultural employment, and retired farmers with descendants in farming, it is still the case that some 90 percent of the electorate has to acquiesce in farm programs that reduce their real incomes. Why does this occur if farm policy is aimed at redistributing income from the 97 percent to the 3 percent?

It is no answer, but nonetheless aids the search for an answer, to note that the same question can be raised about U.S. policy toward the merchant marine, owners of yachts and vacation homes, oil-well drillers, and even partly noneconomic subjects like closing military bases or aid to Israel. The most pertinent discussions of the role of interest group size are in Peltzman (1976) and Olson (1982). Both agree that there is no reason to expect large groups to be politically more successful than small groups, essentially because it is more costly for large groups to handle free-rider problems of collective action on behalf of the group, which may be as simple as joining in hiring a lobbyist.

If we get too comfortable with the idea of the government's inherent desire to aid agriculture, the existence of farm programs may pass from a puzzle to an inevitability. But then how do we explain the absence of effective price supports before 1933? Acquiescence of the interests who successfully opposed farm programs before the New Deal had to be won—at least to the extent necessary to form congressional majorities—to get these programs enacted. It seems evident that the proximate cause of this acquiescence was the perceived economic hardships of farmers in the Great Depression (just as the perception of farm crisis blunts the opposition to farm programs today).

A generalization of this notion is a revealed government preference for the alleviation of undeserved hardship, a publicly expressed altruism that Peltzman (1976) formalized as a system of political indifference curves in which a person's income increases in social value—that is, political willingness to transfer income to him increases—as his income falls.

I have attempted to explain the extent of protection of different U.S. agricultural commodities at different times, using various measures of factors relating to the costs of generating political pressure (Gardner 1983). Seventeen commodities were studied for the period 1910–80.[2] Some have been consistently protected at low levels since 1933 (beef cattle), some at high levels (sugar, cotton, tobacco), some have received accelerated attention in recent years (milk, peanuts), and some have never had significant protection (hogs, eggs). As might be expected, most of the pooled cross-sectional/time series variation in protection cannot be explained by the variables measured. But the number of producers, the geographical instability of production, the concentration of producers and output per producer do reveal themselves as significant political factors. As mentioned above, farm commodities receive more protection when farm income falls, and in addition particular commodities do better when their markets weaken relative to other commodities.

---

[2] The commodities in order of economic importance are: beef cattle, milk, corn, soybeans, hogs, wheat, cotton, eggs, tobacco, rice, sugar cane and beets, potatoes, sorghum, barley, peanuts, oats, and wool.

The preceding factors all affect the government's desire, under political pressure, to aid a commodity group. But it is also important how much it costs—in terms of deadweight loss per dollar transferred—to aid a particular group. This is obvious in some instances. Sweet potatoes, which do not use significant quantities of specialized land, are so elastic in long-run supply that a subsidy program would generate large surpluses without generating much in rents. Also, sweet potatoes are sufficiently elastic in demand so that a production control program would generate a large deadweight loss per dollar transferred. This reasoning suggests that having an inelastic supply or demand function increases the chances that a commodity will be protected, given political pressures, because it is less costly to society to provide such protection. Existing evidence is consistent with this reasoning: relatively inelastic commodities do receive greater protection, ceteris paribus.

More important than the particular results of government intervention in agriculture, is the general outlook on causes of intervention. The general outlook is that redistribution is explained by economic characteristics of the industry determining its ability to lobby and the costs of aiding it. Accordingly, there is no scope for the voters or Congress suddenly to see things in a new light and drastically reform the programs.

Conclusion

The order of magnitude of transfers to agriculture is $9 billion (in rents) at a cost of $19 billion, given 1985 farm programs. This amounts to a gain of $4,000 per farmer at a cost of $190 per nonfarm member of the labor force. Some reasons were given why this transfer occurs, based on comparison of the relative political success of different commodity groups. This sort of explanation may seem (and be) unsatisfactory because it does not explain why farmers get something rather than nothing (or why U.S. farmers are subsidized rather than taxed, as happens commonly in poor countries). In defense, however, it can be said that the type of explanation here is not very different from that used in such mainstream areas of economic research as estimating demand functions. We are usually satisfied being able to show how consumption of Tabasco Sauce varies with price, income, and other variables, although we cannot really explain why anybody eats the stuff at all. Granted, there is a burden of puzzlement about why people we generally assume to be utility maximizers acquiesce in giving money to other much less numerous groups. But we have some general public choice theorizing to help with that. I conclude that explaining redistribution by the social cost of intervention and related variables ought to be just as intellectually satisfying as explaining individual consumption by price and income.

References

Bredahl, M., Meyers, W., and Collins, K. "The Elasticities of Demand for U.S. Agricultural Products." *American Journal of Agricultural Economics* 61 (February 1979): 58–62.

Ferguson, Allen. "The Sugar Price Program." Paper prepared for U.S. Cane Sugar Refiners' Association, May 1985.

Gardner, Bruce L. "Causes of U.S. Farm Commodity Programs." Working Paper, University of Maryland, 1983.

Gardner, Bruce L. "Agricultural Policy." In *Natural Resources and the Environment: The Reagan Approach*, pp. 111–39. Edited by P. Portney. Washington, D.C.: Urban Institute Press, 1984.

Gardner, Bruce L. "Consequences of U.S. Farm Programs." Paper presented at Allied Social Sciences Associations, New York, December 1985.

Gertel, Karl. "Differing Effects of Farm Commodity Programs on Land Returns and Land Values." U.S. Department of Agriculture, Economic Research Service, Agricultural Economic Report No. 544, November 1985.

Johnson, S. R. et al. "Options for the 1985 Farm Bill." In *U.S. Agricultural Policy: The 1985 Farm Legislation*, pp. 119–73. Edited by Bruce Gardner. Washington, D.C.: American Enterprise Institute, 1985.

Norton, Nancy A. "The Effect of Acreage Reduction Programs on the Production of Corn, Wheat and Cotton." Master's thesis, University of Maryland, 1985.

Olson, Mancur. *The Rise and Decline of Nations.* New Haven: Yale University Press, 1982.

Peltzman, Sam. "Toward a More General Theory of Regulation." *Journal of Law and Economics* 19 (August 1976): 211–40.

Phipps, Tim. "Farm Programs and the Rate of Return to Investment in Agriculture." AEI Occasional Paper. Washington, D.C.: American Enterprise Institute, May 1985.

Sumner, D. A., and Alston, J. M. "Effects of the Tobacco Program." AEI Occasional Paper. Washington, D.C.: American Enterprise Institute, November 1984.

U.S., Department of Agriculture. "Joint Statement on Agricultural Policy by former Secretaries of Agriculture Freeman, Hardin, Butz, and Bergland." Washington, D.C.: Department of Agriculture, July 1985.

RENT SEEKING AND FARM COMMODITY PROGRAMS: IS EDUCATION THE SOLUTION?

E. C. Pasour, Jr.

Professor Gardner (1986) presents a good description of the magnitude of the income transfers associated with farm commodity programs. It is ironic that the network of frequently conflicting farm programs instituted during the Great Depression is still in place—and more costly to consumers and taxpayers than ever before. I find little to disagree with in Gardner's paper, and therefore my comment is more an extension than a critique of his points.

Gardner is right about the farm sector's surprising political clout. There is some evidence, however, of an increasing awareness that the protectionist system of agricultural price supports is ineffective or counterproductive in achieving its ostensible objective of promoting the family farm. Willard Cochrane, a long-time supporter of farm commodity programs and former farm adviser to President Kennedy, recently concluded that these programs should be terminated. In his view, the urban revolt necessary to do so can be hastened "by disseminating the right information in the right places" (Cochrane 1986, p. 14).

It is argued below that as the chasm between expectations and the actual effects of farm programs is more widely perceived, there is likely to be a continuing erosion in political support for these programs. Moreover, further increases in agricultural productivity throughout the world will make protectionist domestic farm programs increasingly costly to taxpayers and consumers. It is not clear to what extent changes in economic conditions in world agriculture and "dissemination of the right information in the right places" will affect farm commodity programs in the near term. At the minimum,

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics and Business at North Carolina State University.

however, a wider recognition of the inconsistencies inherent in farm programs and the concomitant harmful effects of redistribution activities by groups using the political process for their own ends is a necessary first step in bringing about fundamental changes in increasingly anachronistic U.S. farm policies.

Some Inconsistencies of Farm Programs

Farm programs redistribute income to higher income farmers. In 1984 nearly one-third of all government payments went to farmers with average net family income of $97,000—about four times the income level of the average American household (Lyons and Collins 1985). Thus, farm program payments, although rationalized as measures to assist low-income farmers, frequently represent a transfer of income from the nonfarm population to farm operators who enjoy higher incomes on average than do those who finance the programs. I agree with Cochrane (1986, p. 11) that there is no defensible reason why the nonfarm sector should be called on to pay higher taxes and food prices to finance these programs.

Other inconsistencies inherent in current U.S. farm programs (Pasour 1986, forthcoming) deserve brief mention here. First, costly price support programs raise consumer prices of milk, butter, cheese, peanuts, tobacco, sugar, and other products. At the same time, billions of dollars are also being spent on food stamps and other food assistance programs to reduce food prices to low-income consumers.

Second, there is a conflict between farm commodity programs and subsidized credit programs in agriculture. Gardner clearly depicts how the billions of dollars spent each year on price support programs *raise* product prices. At the same time, subsidized loans by the Commodity Credit Corporation and Farmer's Home Administration increase the supply and output of farm products, which means *lower* product prices. Thus, by reducing product prices, subsidized credit not only harms producers who do not borrow at subsidized rates but also makes it more costly to support agricultural product prices at any given level.

Third, income boosts from farm commodity programs are transitory because benefits are rapidly incorporated into higher prices of land, allotments, and other specialized resources. The result, as emphasized by Tullock (1975), is that farm programs increase production costs and produce a "transitional gains trap." Once farm programs are initiated, either their elimination or a reduction in price support levels imposes losses on all owners of specialized resources, regardless of whether the affected resource owners benefited from past windfalls.

Fourth, farm programs have little effect on the economic returns to farm labor because the agricultural labor supply is quite responsive to changes in employment opportunities in the nonfarm sector. Thus, human capital and the real return to labor in the rest of the economy are the most important factors determining returns to labor in agriculture. Consequently, as shown by Johnson (1985), changes in farm commodity programs bring about short-run changes in the wealth of owners of land and other specialized inputs, but the programs have little effect on long-run incomes of farm laborers.

Finally, farm commodity programs have been a perennial albatross in U.S. efforts to liberalize trade. Price supports are incompatible with free trade because import restrictions are a necessary component of farm programs that hold domestic prices of dairy products, tobacco, peanuts, sugar, and other products above world price levels. Section 22 of the Agricultural Adjustment Act of 1933, as amended, requires that the U.S. government impose quantity restrictions whenever imports would "materially interfere" with the operation of U.S. farm programs (Dam 1970). This conflict between domestic farm programs and free trade has been obvious since the General Agreement on Tariffs and Trade (GATT) was established in 1947 to liberalize and expand international trade. At the insistence of the United States, agricultural and other "primary products" were not bound by GATT principles that generally prohibit import quotas and export subsidies.

There are increasing pressures to make U.S. farm programs more consistent with an open economy. The 1985 farm bill, unless changed, will be the most expensive in the history of U.S. farm programs. Pressures to make changes in the bill are likely to increase both because of dissatisfaction with farm programs and an increasing concern about budget deficits. At a time when there is widespread concern about budget deficits, rising global farm productivity is increasing the budget outlays required to maintain farm commodity price supports at current levels (Avery 1985). An increased awareness of the unintended effects of farm commodity programs and continuing pressures to reduce federal spending lend more urgency to the question of why these programs persist.

Why do Farm Programs Persist?

As Gardner suggests, "market failure" is not a convincing reason for the continuation and growth in expenditures on government farm programs. A public choice explanation based on the highly concentrated benefits and widely diffused costs of the programs is more plausible. For example, the 10,000 to 15,000 domestic sugar producers may receive program benefits averaging $45,000 per year (Gardner 1981, p. 70). Thus, domestic producers have an economic incentive to devote a great deal of time and money to maintain the sugar program. On the other hand, there is little reason for the individual consumer to devote a great deal of money or time to opposing the sugar program because the average consumer spends less than $50 per year on sugar.

This public choice explanation for the growth of farm programs appears more credible than various "market failure" explanations concerned with monopoly power, public goods, or the increased complexity of modern industrial society (Higgs 1984). However, one is still left with the question of why the amount of rent-seeking activity in agriculture and other areas has increased dramatically over time.

In addition to the standard "market failure" explanations, Higgs (1984) suggests two other reasons for the growth of government agricultural programs: economic crisis and ideology. Economic crisis appears to be an important factor in explaining the growth of these programs since most of the current U.S. agricultural programs were instituted during the economic chaos of the Great Depression. Moreover, farm program expenditures have been at all-time highs during recent years when economic stress in U.S. agriculture was (and is) at the highest level since the 1930s.

Ideology also appears to be important in explaining the persistence and growth of government in agriculture (and other areas). There has been a change in public opinion over time about the appropriate role of the state. Since the 1930s more and more people have come to view government as the problem solver of last resort. At the same time, inhibitions have weakened about receiving income transfers through the aegis of the state. Thus, ideology appears to have played an important role as "transfer activity, originally quite limited, has come to play a much more significant role in the lives of all Americans" (Anderson and Hill 1980, p. 91).

Economic Analysis and Public Policy

Why have the many economic analyses pinpointing the counterproductive nature of government intervention had so little effect on public policy in agriculture? The situation in agriculture is not unique. Stigler (1982) concludes that economic analysis often is disregarded by policymakers because economists are uninformed about the political desires of the community. This explanation is not very convincing. There is a wide gulf between the operation of the political process in the real world and an ideal polity where participants in the political process are not constrained by incentive and information problems in promoting the public good. The existence of uncertainty and the subjective nature of economic data mean that the economist cannot determine "optimal" public policies in agriculture (or in other areas). Moreover, even if most people recognize the desirability of eliminating harmful transfer programs, there is a "you-first" problem. Farmers, like all other recipients of government largesse, have economic incentives to favor reductions in transfers for other groups while maintaining their own. Wide recognition of some government transfer programs in agriculture as bad public policy is but one example of a more fundamental problem, namely, "how to place limits on the *number* and *kinds* of intrusions in which government may engage and how to ensure that it will confine itself to these limits" (Hamowy 1982, p. 143).

There remains an ethical question concerning efforts to achieve wealth transfers through the political process. Gardner concludes that although commodity programs are now in trouble, this fact does "not mean that farmers should regret their past political successes, or that the producers who lobbied for them did not gain real wealth as a result" (p. 257). Although farmers may not regret wealth increases derived from rent-seeking activities, there are important questions about the legitimacy and effects of these activities on the political process.

Mancur Olson (1982) argues that as specialized pressure groups increase, the effect is to gradually strangle the economy. His conclusion is consistent with Hayek's (1979) thesis that the chief threat to the decentralized market order is from the selfishness of individuals acting as members of organized groups.

Ethical questions arise when organized groups use the power of the state to restrict competition as a means of achieving income transfers. Income redistribution through government price support programs inevitably involves coercive restrictions on free exchange. If one accepts Bork's (1984, p. 228) view that there is no principled philosophic difference between economic freedom and individual freedoms of other kinds, individuals have the *right* to engage in mutually beneficial exchange. Arguing that economic freedom is no less important than First Amendment rights, Milton and Rose Friedman (1980, p. 287) have proposed the equivalent of the First Amendment to limit government power in the economic and social areas—

an "Economic Bill of Rights." The restrictions on competition implicit in commodity price support programs are clearly inconsistent with the right of people to buy and sell legitimate goods at mutually acceptable terms.

Both "human rights" and economic education can play important roles in changing public attitudes about the desirability of income transfers achieved through farm commodity programs. People are more likely to transcend the quest for special privilege necessary to reduce rent-seeking activities through constitutional or other means if the similarity of economic rights and First Amendment rights is widely recognized and acknowledged. However, it is not clear whether education or constitutional change is more important in reducing rent-seeking behavior in agriculture (and other areas).

Conclusions and Implications

Gardner presents an excellent summary of the magnitude of income transfers derived through farm commodity programs. I fully agree with him that there is no simple answer to why income transfers per farmer have increased over time, even as the numbers of farms and farmers decreased and farm income, on average, increased relative to nonfarm income. It is quite likely, as Higgs (1984) implies, that the persistence of government farm programs can be traced to a number of sources.

Economists might make a greater impact on public policy in agriculture (and other areas) if it were recognized that public policy cannot be based on marginal efficiency rules because, as Hayek (1948) stresses, the necessary information cannot be obtained to implement the rules. The effort to develop the knowledge necessary to control behavior through the use of efficiency rules is typical of that used in what Buchanan (1982) calls the "morally indifferent" science of economics. In contrast, Buchanan considers the goal of the "morally relevant" science of political economy to be the development of an institutional framework that maximizes the scope for mutually beneficial behavior. In the absence of government intervention, group activities in agriculture (or elsewhere) that seek to restrict competition generally are unsuccessful. Thus, limiting the role of the state is an essential step in minimizing the harmful effects of rent-seeking activity.

It may well be, as Buchanan (1977) and the Friedmans (1980) contend, that a revision of the constitutional contract will be necessary to limit the scope of government and expand the scope for individual choice. Regardless of the method used to increase the scope of voluntary, mutually beneficial behavior, however, a necessary first step is increased public awareness of the effects of redistribution activities in agriculture and other areas.

References

Anderson, Terry L., and Hill, Peter J. *The Birth of a Transfer Society*. Stanford, Calif.: Hoover Institution Press, 1980.

Avery, Dennis T. "The Bad News for Farmers Is That the Global Bad News Is Wrong." Senior Agricultural Analyst, Bureau of Intelligence and Research, U.S. Department of State, before the N.C. Society of Farm Managers and Rural Appraisers, Raleigh, N.C., 28 February 1985.

Bork, Robert H. "A Lawyer's View of Constitutional Economics" In *Constitutional Economics: Containing the Economic Powers of Government*, pp. 227–34. Edited by Richard B. McKenzie. Lexington, Mass.: D.C. Heath and Company, 1984.

Buchanan, James M. *Freedom in Constitutional Contract: Perspectives of a Political Economist*. College Station, Tex.: Texas A&M University Press, 1977.

Buchanan, James M. "The Related but Distinct 'Sciences' of Economics and of Political Economy." *British Journal of Social Psychology* 21(1982): 175–83

Cochrane, Willard W. "A New Sheet of Music." *Choices* 1 (1986): 23–33.

Dam, Kenneth W. *The GATT: Law and International Economic Organization*. Chicago: University of Chicago Press, 1970.

Friedman, Milton, and Friedman, Rose. *Free to Choose*. New York: Avon Books, 1980.

Gardner, Bruce L. *The Governing of Agriculture*. Lawrence, Kans.: Regents Press, 1981.

Gardner, Bruce. "Farm Commodity Programs as Income Transfers." *Cato Journal* 6 (Spring/Summer 1986): 251–61.

Hamowy, Ronald. "The Hayekian Model of Government in an Open Society." *Journal of Libertarian Studies* 6 (Spring 1982): 137–43.

Hayek, F. A. *Individualism and Economic Order*. Chicago: University of Chicago Press, 1948.

Hayek, F. A. *Law, Legislation and Liberty: The Political Order of a Free People*. Chicago: University of Chicago Press, 1979.

Higgs, Robert. "The Sources of Big Government." *Intercollegiate Review* 20 (Spring/Summer 1984): 23–33.

Johnson, D. Gale. "The Performance of Past Policies: A Critique." In *Alternative Agricultural and Food Policies and the 1985 Bill*, pp. 11–36. Edited by Gordon C. Rausser and K. R. Farrell. Berkeley, Calif.: Giannini Foundation, 1985.

Lyons, Dave, and Collins, Keith *Update: The 1985 Farm Bill*. Washington, D.C.: Department of Agriculture, 30 October 1985.

Olson, Mancur. *The Rise and Decline of Nations*. New Haven: Yale University Press, 1982.

Pasour, E. C., Jr. "Inconsistencies in U.S. Farm Policies: Implications for Change." *The Forum for Applied Research and Public Policy*. Forthcoming in 1986.

Stigler, George J. "Economists and Public Policy." *Regulation* 6 (May/June 1982): 13–17.

Tullock, Gordon. "The Transitional Gains Trap." *Bell Journal of Economics* 6 (Autumn 1975): 671–78.

REGULATORY TRANSFERS IN CANADIAN/AMERICAN AGRICULTURE: THE CASE OF SUPPLY MANAGEMENT

Bruce L. Benson and M.D. Faminow

Introduction

Despite many similarities in terms of markets, tastes, standards of living, resources, technology, education, and political orientation, Canada and the United States have quite different patterns of agricultural transfer programs. The most prominent feature of Canada's complex agricultural policy is the emphasis on mandatory marketing programs, such as the Canadian Wheat Board grain delivery quotas and supply management programs in the poultry sectors. In contrast, American farm policy, while equally complex, favors the use of price supports and acreage reduction programs, particularly for "major" farm commodities, but such markets as the U.S. poultry sectors do not enjoy any direct price or income enhancing policies.

The assumption that agricultural policy is a response to some underlying need to correct a market inadequacy leads to the following question: If the production and consumption of agricultural products reflects similar supply/demand relationships and, further, exchange takes place in markets of similar structure (often prices are determined at the world level), then why are very different forms of agricultural transfer prevalent in the two countries? This question becomes more striking when it is recalled that many current policies evolved from the same historical episode—the agricultural crisis popularly associated with the Great Depression. Conceivably, Canadian and American farmers, facing similar economic problems, pro-

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

Bruce L. Benson is Associate Professor of Economics at Florida State University and M. D. Faminow is Assistant Professor of Agricultural Economics at the University of Arizona. The authors are grateful to Ian Willis for comments on an earlier draft of this paper.

ducing the same goods, and exchanging these commodities in interrelated markets that destine food products to similar consumers might be expected to end up with support policies that also are similar. After all, the "public interest" should be quite similar under such circumstances.

The goal of this paper is to address the issue of comparative Canadian/American agricultural policy. The breadth and complexity of agricultural policies in both countries make it impossible to examine all the similarities and differences here. In fact, the intention of the paper is far more modest. It deals specifically with one striking difference: the prevalence of supply management programs for specific agricultural commodities in Canada that have not been subject to any direct price or income support in the United States. We begin with a general discussion of the competing paradigms that propose to explain and interpret economic regulation.

Theories of Economic Regulation

At some risk of oversimplification, it is suggested here that five perspectives dominate academic thinking about the causes of economic regulation. These paradigms are summarized below as the public interest, Marxist, capture, interest group, and bureaucratic interest theories of economic regulation. The last four are closely related in that they all conclude that private interests determine regulatory policy. Thus, we begin with the public interest paradigm.

Public Interest Theory

The public interest theory of economic regulation has enjoyed wide implicit support from academicians and rhetorical support from policy makers. It is based on two assumptions: first, markets are fragile and tend to operate inefficiently; and second, government regulation is costless or, at least cheap (Posner 1974). Thus, regulation is the end result of a public response to some market inefficiency or inequity and is implemented to benefit society as a whole, or perhaps some important subset of society. Conceivably, in cases where minor subsets of society benefit it is because, at least implicitly, society has judged it important to provide a transfer to this group. If the regulation requires a transfer of income to a subgroup, then it must be that society is willing to pay the price of support. (This, of course, is an argument commonly used to describe the reason for the costly array of farm policies prevalent in Canada and the United States.)

This theory, at least in political rhetoric, does not provide an adequate description of economic regulation. Sophisticated policy analysis is not needed to observe that many economic regulations do not operate in any general interest or as a consequence of market inefficiencies. Rather, in many cases they benefit a select few. Any explanation for the existence of these policies, therefore, must rely on the "willingness of society to pay the price" argument.

Agriculture provides an obvious case in point. Canadian and U.S. agriculture is heavily protected and subsidized by the public through high food prices and public expenditures. Although consumer and taxpayer input may be a recognized and perhaps increasing component of American agricultural and food policy (Spitze 1978), agricultural production interests continue to dominate policy.[1] For instance, public debate about the Canadian Farm Products Marketing Agencies Act, which provided for wide-reaching supply management policies that would greatly increase the cost of food in Canada, contained no major input from consumer and agribusiness interests (Skogstad 1980). Thus, as a general theory of economic regulation, the public interest model can be discounted and, perhaps, rejected.[2] In particular, this appears to be the case with the specific agricultural policies examined here, as explained in more detail below. If regulation is not always in the interest of the public, whose interests dominate? We briefly consider four private interest arguments.

Marxist Theory

Marxists argue that identifying the relations between classes is the crucial link to understanding society and societal change. Through control of the institutions (including regulation) in society, capitalists are in a position to demand and obtain benefits in the regulatory process—in particular, the extraction of surplus from the working class. Thus, the state, the institutions created by the state, and the policies of the state reflect the interests of those who control the means of production.[3] Since the state is essentially an institution designed to facilitate surplus-extraction by the ruling class in this viewpoint, it follows that regulation is designed to systematically favor capitalists.

---

[1] See Gardner (1980) for a description of U.S. agricultural policy and the complex and often conflicting regulations that influence and shape American agricultural production.

[2] Complete rejection of the concept of public interest may be premature. Even authors often associated with the interest group school of thought described below have pointed out the importance of societal norms and values in policy development. For example, see Buchanan and Wagner (1977).

[3] "The state's action in maintaining and guaranteeing Capitalism as a system is therefore just another way of saying that state action, in the most general sense, is an expression of the power of the dominant class" (Nore 1977, p. 198).

Posner (1974, p. 341), however, suggests that the Marxist scenario is severely flawed because "a great deal of economic regulation serves the interests of small business—or nonbusiness groups, including dairy farmers, pharmacists, bankers, truckers, and in particular, labor unions." Perhaps the greatest weakness in the Marxist viewpoint is the failure to recognize that a capital-labor class distinction has increasingly become an inadequate description of modern society. The separation of labor and capital is not distinct. Moreover, upward mobility is not a trivial occurrence in Western economies. Thus, the search for a sufficient Marxist interpretation of modern economic life and regulation is a discouraging exercise.

Capture Theory

Proponents of the capture theory of regulation argue that the original good purposes of regulation are thwarted by the efforts of regulated firms that eventually dominate regulatory agencies.[4] In other words, regulation designed to reduce the ill-effects of market failure (monopolies or externalities, for example) leads the business interests to focus attention and resources in efforts to dampen the regulatory impact. Ultimately, the business interests might be expected to obtain benefits from regulation. That is, they "capture" the regulatory agency and use this control to promote regulation and policy in their interests.

This theory also has major flaws. In particular, it fails to explain why the industry is the only group able to organize and effectively influence or maintain control of regulation. Customers of the industry may also have strong incentives to seek benefits from regulation and "capture" the agency. The capture theory also fails to explain why the industry does not enter the political process prior to the establishment of regulation and simply prevent formation of the agency it is strong enough to capture, or, since the industry is able to capture the benefits from regulation, why it does not seek creation of an agency specifically designed to promote its interests. Moreover, it defies most regulatory experience. Much economic regulation is unabashedly designed to assist or reward a specific group in society (for example, farm policy designed to "save the family farm"). In those cases, there is no capture process, hence no explanation is provided for the existence or form of the regulation.

In a variant of the capture theory, Galbraith (1973, pp. 155–63) attributes the success of big business to the power of what he calls the "planning system"—a somewhat nebulous group of large, tech-

---

[4] This paragraph and the next draws heavily from Posner (1974).

nologically inclined corporations. The close association of the planning system and the state makes it easy for large firms to obtain regulatory policies that suit their needs. Galbraith ascribes the success of large firms in obtaining beneficial regulation to three sources: (1) persuasion, or advertising and public relations expertise; (2) bureaucratic symbiosis, or the mutual goals and needs of the bureaucracy and the planning system; and (3) capital-labor alliance, or the easing of conflict between capital and labor. When necessary, the planning system is able to press its demands on the state and obtain favorable regulation. However, like the capture and Marxist theories, this argument does not explain why some industries in the planning system are successful, while others are not. Further, this argument does not indicate why economic regulation also embraces segments of small business and agriculture.

Interest Group Theory

The interest group theory of regulation holds that policy results from the lobbying efforts of specific interest groups.[5] Stigler (1971) described economic regulation as a supply and demand process with political interest groups on the demand side and legislators (and their political parties) on the supply side. Regulatory legislation is designed to generate wealth transfers from unorganized or politically ineffective citizens to politically powerful interest groups. To become politically effective and seek wealth transfers, interest groups must overcome the cost of organizing and expressing their demands to legislators. Organizing costs can be substantial when large numbers of individuals are expected to benefit from the collective effort because of the need to overcome the free rider problem. Furthermore, if per capita wealth transfers are small or difficult to recognize for all potential beneficiaries, no single individual may be willing to take the initiative to organize other potential gainers. Thus, relatively small groups with large and easily recognizable potential gains per capita are most likely to overcome the cost of organizing.[6] This describes many regulated industries composed of a small number of firms that reap large transfers as a result of regulatory limits on entry, price competition, and the like. Consumers are not likely to be effective in the political market because of their large numbers and the small, not easily distinguishable per capita transfer that might be avoided. Stigler's theory recognizes the potential for entry of effective nonindustrial interest groups in cases where the free rider problem does not dominate (for example, if the group is small and/or per capita gains are large). Nonetheless, he concludes that business groups are almost always more likely to seek and obtain transfers than their customers are to avoid such transfers.

---

[5] Posner (1974) has labeled this general approach the economic theory of regulation and generally credits Stigler with being the originator. This development was actually preceded by the work of Downs (1957), Olson (1965), and others from both political science and economic disciplines, that differed more in form than substance. However, the works of Stigler (1971, 1974), Peltzman (1976), and Posner (1974) were responsible for directing economists toward a much different policy perspective (for example, see Becker 1983). In particular, by explaining regulation in terms of a market with both demand and supply, a more systematic process of organization was presented.

[6] Others have simply accepted Stigler's argument and assumed that active groups are those which can control free riding relatively easily because they are small in number and gains to members are easily identifiable (for example, Becker 1983, p. 388).

Stigler's theory did not explain why some relatively large groups, such as farmers, have been very effective at obtaining transfers through regulation. However, in a subsequent addendum to his theory, Stigler (1974) presented an explanation for transfer seeking by large interest groups. He contended that if there were considerable asymmetry of interests within an industry made up of a large number of firms, the individual incentives of *some* of the producers to act for the group would be substantial. Thus, for example, the largest firms in a highly concentrated industry may have strong incentives to take the initiative in seeking regulatory transfers because their share of the expected gains will be large. Stigler renamed the free rider problem the "cheap rider problem" to stress the idea that large potential gains for some, but not all, members of a group can provide sufficient incentives for those individuals to seek regulation, even if many others obtain small benefits without contributing to the transfer-seeking effort.[7] For example, the common observation that farm policy tends to favor large producers and increase farm income inequality suggests perversity in the public interest view but is quite consistent with asymmetric interests.

The interest group theory of regulation does have a major conclusion that corresponds closely to the Marxist and capture theories. Business groups typically have stronger per capita incentives (usually because of smaller group membership and frequently because of considerable asymmetry) to overcome organizing costs than do consumer groups. Therefore, given the potential transfer of consumer surplus as an incentive, an industry is more likely to organize and seek favorable regulation than consumers are to avoid it. This conclusion is strengthened considerably with recognition that regulation typically generates other conflicts besides the obvious one over consumer surplus.[8] In fact, producers may be able to obtain transfers through regulation from nonconsumer surplus sources (Benson and Faminow 1986). This occurs when producers are not the resource owners in an increasing cost industry. What is typically called producer surplus, therefore, is really resource supplier surplus, and it is transferable. In such cases the rents that can be obtained through regulation include a transfer from resource suppliers as well, and therefore exceed the losses consumers (or resource suppliers) bear. Under such circumstances the interest group conflict over regulatory policy potentially will involve the two ends of the vertical transformation of resources into consumption against the middle, but the aggregate incentives of the group in the middle (the producers) are greater than the separate incentives that the two ends (consumers and factor-owners) face to avoid such regulation.[9]

---

[7] Wilson (1980) has pressed this point even further. He pointed out that even when interests are not narrowly focused a "skilled entrepreneur" may serve as a "vicarious representative of groups not directly part of the legislative process" (1980, p. 370). Thus, a single individual may claim to be representative of a widely dispersed and unorganized group if the benefits, perhaps in terms of personal satisfaction rather than monetary gain, are sufficient to induce that individual to specialize as a political entrepreneur. There clearly are a few "consumer advocates," "environmental activists," and others who appear to have had some impact on regulation, but relative to the magnitude of overall regulatory transfers their impact is modest.

Posner (1974) added to Stigler's analysis by stressing that the decision to enter the political market for regulation is like any investment decision. Resources will have to be used to generate the expected benefits (although, as the rent-seeking paradigm stresses, these resources are consumed to produce a welfare-reducing transfer rather than a welfare-enhancing increase in physical output). Thus, the decision to enter into any collective action depends on the opportunity cost of the resources that would be used in the transfer-seeking process. A group may effectively organize to seek very small per capita transfers if the transfers are large *relative* to the membership's opportunity costs. This explains, to a large degree, the high level of political activity by senior citizens' groups.

One other explanation for the successful organization of many interest groups is that organization costs "are like start-up costs. Once they are borne, they do not affect marginal costs" (Tollison 1982, p. 590). Some groups have strong incentives to bear these start-up costs, which may be unrelated to their efforts to obtain favorable regulation.

---

[8] There may also be competition between members of a group or industry over group allocation of transfers (for example, who gets quota rights). See Benson (1983) for an examination of the role played by competing banking organizations in the development of U.S. bank merger regulation, for instance.

[9] See Benson and Faminow (1986) for a detailed examination of this argument, including consideration of the implications of more than three interest groups.

Labor unions and many trade associations fall into this category. Once organized, for whatever reason, such groups are likely to perceive only minor marginal costs in seeking wealth transfers through economic regulation.

The likelihood of entry into the political market for wealth transfers generated through regulation might be summarized and expressed algebraically as

$$S_i = S_i(N_i,T_i,K_i,D_i,B_i), \frac{\partial S_i}{\partial N_i} < 0, \frac{\partial S_i}{\partial T_i} > 0, \frac{\partial S_i}{\partial K_i} < 0, \frac{\partial S_i}{\partial D_i} > 0, \frac{\partial S_i}{\partial B_i} > 0, \quad (1)$$

where S_i represents the probability that group i will organize and/or its representatives will seek regulatory benefits. This is a function of: N_i, the number of potential members of the group; T_i, the potential per capita transfer to the group's members (or perhaps the transfer away from the group that its members wish to avoid); K_i, the opportunity cost of the resources the group would use in seeking transfers, which may include consideration of the probability that another group will oppose this group's demands; D_i, the distribution of the potential transfer among the group's membership measured by something like a Herfindahl Index (for example, as $D_i \rightarrow 1$ a few members expect to obtain large gains, while $D_i \rightarrow 0$ implies a relatively even distribution of the gains); and B_i, the benefits from organizing that do not come through the regulatory process.

One criticism of the interest group theory as it has developed from Stigler (1971) to Peltzman (1976) and most recently to Becker (1983) is that it treats the government itself as a costless transfer mechanism. In particular, the institutions and people involved in the regulatory process have no impact on the outcome of the process. Hirshleifer (1976), in commenting on Peltzman (1976), pointed out that regulators themselves constitute an interest group that benefits from regulation, and indeed regulatory authorities behave much like any other interest group in trying to influence passage of laws delegating regulatory powers (Benson 1983). Some writers attribute considerably more influence to regulators—be they civil service bureaucrats or appointed regulatory commissioners—and propose a bureaucratic theory of regulation.

Bureaucratic Theory

McKenzie and Macauley (1980, p. 298) "contend that much regulation is purposefully designed by public bureaucracies to make the private sector inefficient, increasing the relative attractiveness of the public sector." This bureaucratic theory of regulation (also see Clarkson and Murio 1978; Russell and Shelton 1974; Echert 1973; and Hilton 1972 for models wherein the interests and behavior of regulators play central roles) falls into the general grouping of private interest theories (including Marxist, capture, and interest group theories) but in this case the private interest of those doing the regulating dominates. The interests of the regulators are, of course, a function of the institutional incentives they face. Thus, the bureaucratic theory of regulation draws upon Niskanen's (1972) theory of bureaucracy. Bureaucratic regulators are typically assumed to be budget maximizers (McKenzie and Macauley 1980; Eckert 1973) because such incentives as salary, power wielded, prestige associated with the position, and other perquisites of office are an increasing function of the size of the regulatory bureau as measured by budget.[10] Such incentives can lead to inefficient forms of regulation and excessive levels of regulation relative to what is desired, say, by the median voter (McKenzie and Macauley 1980) or by politically powerful interest groups (Benson 1983).

The bureaucratic theory of regulation has occasionally been treated as being in conflict with the interest group theory; it has been proposed that either interest groups or bureaucrats dominate (Weingast and Moran 1983). In fact, however, the two theories are complementary, and the bureaucratic theory can easily be incorporated into the more general interest group approach (Benson 1983; Benson and Greenhut 1986). Bureaucrats have incentives to overregulate and regulate inefficiently, and such incentives would dominate if they went unchecked. Those who represent the demands of interest groups (congressmen and members of Parliament), on the other hand, wish to avoid such inefficiencies and excesses in the regulatory process in order to generate "efficient" transfers such as those predicted by Peltzman (1976), Becker (1983), and Gardner (1983). These representatives establish the institutional framework (incentives) within which the bureaucrats must function, and appropriate the agencies' budgets. Thus, they attempt to control the regulatory agencies, but as Niskanen (1975) pointed out for agencies in general, legislators face a constrained maximization problem. Bureaucrats simply cannot be perfectly monitored by elected representatives who also must gauge the demands of the wide variety of special interests, determine the political strength of competing demands, produce sufficient rhetoric, visibility, and transfers to raise campaign contributions that will lead to reelection, and so on. As a consequence, bureaucrats can have some influence on the outcome of the regulatory process (Benson 1983), without having the dominant influence Weingast and Moran (1983) feel the bureaucratic theory implies. In addition, of course, those in government may form powerful political interest groups themselves that may increasingly determine what governments do, while the influence of private sector interest groups declines in a relative sense (Benson 1984).

---

[10] Commissioners, on the other hand, have often been viewed as "squawk minimizers" who attempt to minimize controversy and, therefore, their work load because their income is generally not tied to the size of their agency, in contrast to a bureaucratic manager (Hilton 1972; Eckert 1973). However, power, prestige, and other perquisites are directly related to budget size (and by expanding staff a commissioner may reduce work load anyway), so while incentives faced by commissioners may differ in magnitude, they do not differ in direction (Benson and Greenhut 1986).

The Case of Supply Management

Supply management is, in many ways, an extremely powerful tool for reallocating income. In Canada, supply management is prevalent at the national level in the production of the major poultry commodities—eggs, broilers, and turkeys. The case of grain is somewhat different. Most Canadian grain production is regulated by Canadian Wheat Board delivery quotas that specify delivery conditions (location, time, amount) for Board grain but do not directly control off-Board grain (for example, cattle feed). Of course, through control of export-oriented grain marketing indirect influence on off-Board markets is exerted. The major livestock commodities (cattle, hogs, and sheep) are not subject to direct marketing restrictions; there are provincial hog marketing boards, but they do not have formal power to set prices. Poultry sector control involves direct production quotas. The omnibus Farm Products Marketing Agencies Act (FPMAA) authorized national supply management policies in the poultry sectors.

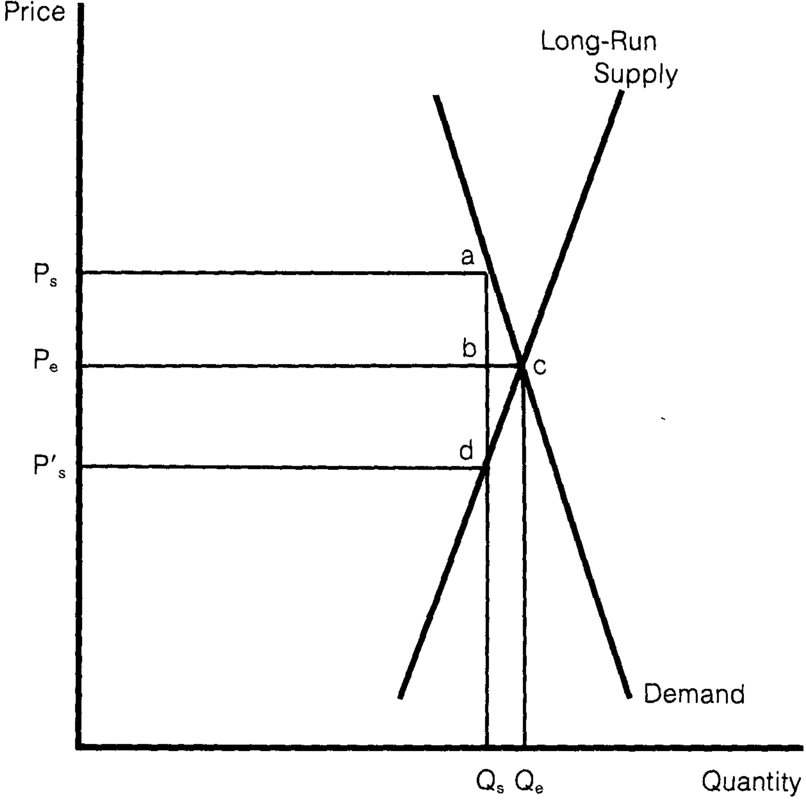
On the surface these policies contrast sharply with the United States, where, for instance, the poultry sectors enjoy no comparable government support. Furthermore, the most well known (costly) U.S. farm programs (wheat, corn, other grains, dairy, cotton, rice, wool and mohair, and honey) have price support systems that encourage production of surpluses, which are purchased by the government. Such programs, however, exist for only slightly more than one-third of the types of commodities produced by U.S. farmers (although they are the "major" commodities planted on 80 percent of U.S. cropland). Many other crops (especially such specialty crops as fruits, vegetables, and nuts) are controlled by marketing orders that establish quality standards, regulate the flow of products to primary markets by diverting produce to secondary markets, and facilitate marketing practices (for example, container standardization), rather than directly restrict supply to enhance prices. Thus, regulation of many U.S. farm commodities corresponds loosely to the Canadian system, with the primary difference being that production is not directly restricted. In addition, neither country provides any major price or income support to one major commodity—beef cattle. Policy differences, therefore, are not as significant as one might expect when examining the most visible agricultural programs.

The passage of the FPMAA in January 1972 was, and remains, a controversial decision. Four years after the first proposed legislation, this act created the umbrella national marketing legislation to legitimize the use of supply management to enhance and stabilize farm income. Despite the attractiveness that higher and more stable income levels would appear to hold for Canadian agricultural interests, "[t]he bill provoked unprecedented controversy and contention" (Skogstad 1980, p. 91). The Canadian Cattlemans Association, the Saskatchewan Stock Growers Association, and the hog marketing boards in the western provinces strongly opposed the inclusion of livestock in the blanket legislation (Skogstad 1980). In addition to debate about the general merits of supply management and what sectors to include, groups that supported the concept of the FPMAA insisted that the marketing board representation be explicitly designed to be responsive to producer interests.

The transfer consequences of supply management in Canadian poultry markets are illustrated in Figure 1 and Table 1. The competitive equilibrium in a market (P_e and Q_e in Figure 1) is prevented by restricting total production to some level such as Q_s through a quota system, thus raising price to P_s. Empirically, the result is a small deadweight loss, abdc (see Table 1), and a large transfer from consumers, P_s abP_e (Veeman 1982; Schmitz 1983). A large transfer from resource suppliers also occurs, as explained below. Note, furthermore, that the values in Table 1 represent one year's transfers, so over time the value of such programs to producers can be very large.

We use 1979 data provided by Veeman for eggs, broilers, and turkeys. Long-run adjustments take place rapidly in these markets as compared with many other agricultural markets. Thus, the supply estimates using one year's data are likely to approximate the long-run functions. Unlike many agricultural industries where land owned by farmers appears to be the resource that claims the bulk of the rental return to a regulatory restriction, production in these three industries uses relatively little land. For example, the purchase of processed feed represents about 72 percent of broiler production costs (Henson 1982). Depreciation and interest expenses can be used

FIGURE 1
SUPPLY MANAGEMENT REGULATION



as a proxy for the shares of broiler production costs that can be allocated to producer-owned land and capital resources. Based on Henson's data, these account for about 5–6 percent of broiler production costs. The percent share of production costs attributable to farmer-owned resources for the turkey and egg industries are similar, although there are differences in production processes. For example, turkey production typically requires relatively more land resources (land usage is still minimal when compared with other agricultural sectors and with total costs), and egg production employs more specialized automatic equipment. Thus, considerable transfers from resource suppliers are possible, provided supply is not highly elastic.

The estimated loss to buyers and resource suppliers in terms of both transfers and deadweight losses, and the rents available to producers, assuming producers own none of the resources that cause the upsloping long-run supply, have been calculated in Table 1. These rents (transferred from resource owners) are likely to be biased

TABLE 1

PRODUCER GAINS AND CONSUMER AND RESOURCE LOSSES UNDER CANADIAN SUPPLY MANAGEMENT IN THE POULTRY MARKETS

Commodity	P_s-P'_s ($ Cdn)	Producer Rent[a]	Consumer Transfer Loss[b]	Resource Owner Transfer Loss[c]	Deadweight in Producer (Resource Owner) Surplus	Loss[d] in Consumer Surplus
		($ million Cdn)				
Eggs	0.07	29.472	26.525	2.947	0.015	0.138
(dozens)	0.12	50.523	38.314	12.209	0.091	0.286
	0.25	105.257	98.100	7.157	0.137	1.884
Broilers	0.07	60.831	41.711	19.120	0.915	0.238
(pounds)	0.12	104.282	72.787	31.495	1.394	3.213
	0.16	139.042	100.338	38.704	2.357	6.151
Turkeys	0.04	9.026	4.401	4.625	0.075	0.074
(pounds)	0.26	58.666	35.841	22.825	3.033	4.871

[a] Corresponds to $P_s adP'_s$ in Figure 1.

[b] Corresponds to $P_s abP_e$ in Figure 1. Therefore, *to find the transfer* from resource suppliers, subtract the consumers transfer loss from producer rents.

[c] Corresponds to $P_e bdP'_s$ in Figure 1.

[d] Total deadweight loss requires summation of these two columns, the first of which corresponds to bcd and the second to acb in Figure 1.

SOURCE: Developed from data provided in Veeman (1982, p. 29).

slightly upward, since producer ownership probably accounts for somewhere between 5 and 10 percent of the resources, and perhaps even more. Thus, 5–10 percent of the values in resource supplier transfers in Table 1 actually are not transfers, but true reductions in producer surplus. We also indicate the deadweight loss in producer (resource supplier) surplus since it is assumed to be a loss to resource owners. Estimates are made for different price levels to demonstrate that the transfers clearly depend on the strength of the regulation.

Critical to the theoretical arguments and empirical estimates presented above is the supply elasticity used to generate the linear supply function. Veeman assumed that the supply elasticity was 1.0 in each of these markets. This assumption is reasonable although perhaps high, given other empirical estimates. For example, in Harling and Thompsons's (1983) review of the literature on estimated supply elasticities for poultry and eggs in Canada, estimates for poultry ranged from 0.12 to 1.01 and between 0.03 and 0.94 for eggs. Observed supply elasticities in regulated industries also may be high relative to what the elasticity of the competitive supply curve would be, because of the capitalization of regulatory generated rents into the price of producer-owned resources (Benson and Faminow 1986). However, Borcherding and Dorosh (1981) argue that econometrically estimated supply elasticities for eggs in Canada are too low. The basis of their argument is that all input factors of egg production (including expertise) have a perfectly elastic supply, so that the egg supply function should also be perfectly elastic. Table 2 shows calculated producer rent values under alternative elasticity assumptions. The estimates in Table 2 clearly indicate the relationship between the elasticity of supply and the size of the economic transfers from resource suppliers.

The Basis for U.S.–Canadian Policy Differences

Why are policies in place to protect poultry sectors in Canada but not in the United States? The perspectives provided by the five theories discussed above are useful in examining the question of why this regulatory transfer program was established in Canada. Clearly, the public interest theory of regulation cannot be rejected simply because a small deadweight loss arises and a large transfer to poultry producers from both consumers and factor owners occurs. Perhaps a consensus actually does exist in Canada that farmers deserve such costly transfers. However, there are reasons to doubt that this is public interest regulation. First, poultry farmers are being favored at the expense of some other farmers—for example, those producing

TABLE 2

PRODUCER GAINS AND RESOURCE OWNER LOSSES UNDER CANADIAN SUPPLY MANAGEMENT, GIVEN ALTERNATIVE SUPPLY ELASTICITIES FOR EGGS

Supply Elasticities for Eggs	P_s-P'_s	Producer Rent	Consumer Transfer Loss	Resource Owner Transfer Loss	Deadweight in Producer (Resource Owner) Surplus	Loss in Consumer Surplus
	($ Cdn)	($ million Cdn)				
0.1	0.130	54.734	26.525	28.209	0.284	0.138
0.5	0.077	32.419	26.525	5.894	0.031	0.138
1.0	0.070	29.472	26.525	2.947	0.015	0.138
1.5	0.068	28.629	26.525	2.104	0.011	0.138
20.0	0.063	26.525	26.525	0.000	0.000	0.138

SOURCE: Developed from data provided in Veeman (1982, p. 29).

cattle. Thus, the public consensus would have to be one of favoring poultry farmers over those producing cattle. Second, some vertical integration has developed in the poultry sectors. Farms that produce eggs as inputs for bakeries and other processed foods are often owned by those food processors. Some large wholesalers of chickens and turkeys process and package birds from their own farms. And finally, of course, no matter what the political rhetoric is, the lobbyists for such regulations are the farm groups who receive the transfers, not the consumer (or supplier) groups who give them. Thus, "public opinion" is frequently the farmers' (and their political representatives') expression of what "public opinion" should be. Some version of the special interest theories of regulation, therefore, would appear to apply.

We have already rejected the Marxist theory of regulation, but note that the above description of the transfer process in these markets is itself incomplete. We describe a potential three-group conflict (consumers, poultry farmers, and input suppliers) since the largest transfers can be so grouped. In fact, these markets and the competition for transfers within them are much more complex. There has been, for example, competition within the poultry industries for the allocation of quota rights (and therefore transfers). In addition, there can be several different groups of input suppliers and even consumers for each of these products, and there are also middlemen. The food retailing industry in Canada is highly concentrated. Mallen (1976) estimated the 1973 four-firm concentration ratio in Canadian food retailing to be 44 percent. Analysis of market shares for 32 large urban areas resulted in four-firm concentration ratios of 71 percent. On a regional basis the market concentration is often considerably higher, ranging from 66 percent in Ontario to 90 percent in the Prairie provinces of Alberta, Saskatchewan, and Manitoba. Most of the four-firm market share in Canada's western provinces is accounted for by a single firm. Beyond that, the fast-food market for broilers in Canada at the time of the legislation was dominated by one firm—Kentucky Fried Chicken.

Clearly, some of these highly concentrated, relatively asymmetric middlemen buyers of poultry products might fit the Marxist definition of capitalists, as might poultry farmers, given the relative capital intensity of production (and many input suppliers, for that matter), but middlemen interests frequently conflict with those of farmers when it comes to regulation. Along with farmers, middlemen (supermarkets, restaurants, and the like) may desire output restrictions to raise retail prices, but they will not want high wholesale prices. Thus, "capitalists" would appear to be in conflict with each other over the allocation of the potential transfers described above. In his analysis of marketing boards in Ontario, McManus (1979, p. 47) concluded, on the basis of what was admittedly sketchy evidence, that "the available information seems to indicate that in the broiler industry we have two monopolistic sectors dealing at arm's length with each other and engaged in some strategic conflict over the division of monopoly rents." (See Benson and Faminow 1986, for the implications of more than three vertically linked interest groups in the context of the interest group theory of regulation.) The simple capital versus labor view of regulation clearly does not apply in this case.

One can also question the capture theory as an explanation of supply management in Canadian agriculture. Farmers did not capture the regulators after they were set up to provide some sort of national welfare-enhancing service, such as protecting consumers, controlling monopoly, or reducing externalities. The original purpose of agricultural legislation, despite occasional claims of intent to insure the supply of consumer necessities, was obviously to bolster the income of farmers. The capture theory does not generalize to agricultural policies, even if it appears to explain some other types of economic regulation.

We now turn to the interest group theory of regulation. Supply management systems establish cartels (Borcherding and Dorosh 1981).[11] The incentives of producers to organize and seek legal support of such a cartel, reflected in Table 1, are obviously strong. It would appear that in Canada these incentives are sufficiently strong for the producers to bear the costs of organizing and demanding such regulation, while potential opposition groups have not effectively organized. Of course, similar potential transfers (in per capita terms) would appear to face producers in U.S. poultry markets. The question then becomes why, if the interest group theory is valid, have U.S. poultry farmers failed to obtain the same types of transfers that their Canadian counterparts receive (of course, the same kind of question should be asked of anyone claiming that public interest, Marxist, or capture theories explain such regulation). Clearly, a bill granting the right to establish a legal cartel is enviable legislation. Therefore, in developing the case for (and against) an interest group explanation of Canada's supply management system in poultry-related markets we shall simultaneously address the question of why U.S. markets are not similarly regulated. We concentrate on the summary of the interest group model presented in equation 1.

---

[11] An effective supply management program provides an industry with mandated cartel power, although, of course, the problems and costs associated with maintaining and policing the cartel may not be trivial. A relatively weak cartel must rely upon input-restricting measures, such as U.S. programs to reduce planted acreage. If member output can be more directly regulated (for example, through marketing restrictions), then the possibility of cheating against the cartel is diminished and the monoply power more complete. Potent supply control is a necessary but not sufficient prerequisite for an effective cartel. It is not sufficient because the magnitude of enforcement costs also require consideration.

The difference in the size of the poultry sectors in the two countries is substantial. It is clearly more difficult (costly) to organize the larger number of U.S producers than the smaller number of Canadian poultry farmers. Some small commodity groups in the United States (for example, hops, spearmint oil, Florida celery) have organized and obtained supply management marketing order systems, while larger commodity groups, even when successful in obtaining income support (for example, wheat and corn), have failed to achieve effective cartel arrangements. The N_i term in equation 1 appears to be important. (Note that expansion of N_i to encompass several related variables such as absolute number, geographic dispersion, and contracting costs may be appropriate.)

The FPMAA was passed in 1972, but by 1949 the Federal Agricultural Products Marketing Act, along with complementary provincial legislation, had created the legal framework under which effective marketing boards could be established. To a large extent negotiation to establish supply management controls under the auspices of the FPMAA involved negotiation with provincial marketing boards already in existence. Clearly a small numbers advantage was present in Canada under this arrangement.

Furthermore, the potential transfers may not be as similar for the U.S. and Canadian markets as one might expect. The size of the potential gain from cartelization depends highly on the underlying supply and demand elasticities. If demand is more elastic in the United States, then the potential gains from cartelization are lower than if a less elastic demand prevailed.[12] Estimation and comparison of the relevant demand functions are difficult because the distortion due to existing policies prevents estimation of the "true" relationships. However, some anecdotal evidence can be provided. Canadian per capita consumption of chicken is greater than in the United States, despite the higher real prices paid in Canada. This suggests that Canadian demand is relatively inelastic. Hence, cartelization and supply management would be more effective in raising cartel revenues, leading to higher relative per capita gains and a greater incentive to organize.

---

[12] For more discussion on this point see Gardner (1983), Faminow and Benson (1984), Borcherding and Dorosh (1981), and Benson and Faminow (1986).

The opportunity cost of obtaining favorable regulation also appears to differ substantially for Canadian and U.S. poultry farmers. This does not mean that a single unit of a farmer's time (or resources) is worth more in one country than in the other. Rather, it appears that U.S. poultry farmers may have to expend considerably more resources to obtain political support than do their Canadian counterparts. Geographic asymmetry in production, for example, is more pronounced in the United States than Canada. A major share of U.S. production is located in the southeastern states, but in Canada the geographic distribution of poultry production is much more closely tied to the geographic distribution of the population. Geographic asymmetry in the United States implies not only that organizing costs could be relatively low, but also that political influence will be more expensive. Many elected parliamentarians in Canada have poultry farmers in their election districts, and, therefore, direct voter and campaign support (or threats of opposition) can be effective. U.S. poultry producers, on the other hand, are likely to be able to directly offer *both* votes and campaign contributions in the election of only a relatively few senators and congressmen. Of course, campaign contributions (and bribes) to congressmen and senators in other districts can be effective. Money has considerable purchasing power in the political marketplace, but votes (and threats of political disturbances like strikes and riots) also are important (Posner 1974). It may take more money (or in terms of opportunity costs, a greater sacrifice of resources or goods and services that could be purchased) for American poultry farmers to achieve the kind of benefits that exist in Canada. Vote trading (logrolling) is certainly commonplace in the United States and plays an integral role in the passage of special interest legislation (Benson 1981), but few logs have to be rolled when each elected representative has a direct reelection interest in a particular group's welfare.

These characteristics of the U.S. and Canadian poultry markets are important factors in explaining the political success of Canadian poultry farmers and lack of success by U.S. producers. However, the relative cost of obtaining favorable regulation may also be influenced by the differences in the organization of political processes between the two countries. In particular, we suggest that the necessary lobbying procedure in a parliamentary system may systematically favor the ability of specific producer groups to obtain highly favorable cartel legislation. The U.S. representative system, in contrast, may make passage of this form of legislation relatively more costly.

Our argument is based on the observation that the focus of policy formulation in a parliamentary system is quite narrow, primarily originating within the Cabinet (and in some cases, the inner-Cabinet). Enforcement of party line voting and, therefore, the relative lack of logrolling insures that members of Parliament in the governing party support a bill, even if the legislation is not conducive to reelection of individual members.[13] In short, consensus or majority support is not necessary in a parliamentary system. Cabinet members with party clout can push through legislation and exert pressure on party members for support, even if the best interests of some are not promoted. Of course, this does not suggest that a parliamentary government can be unresponsive to opposing viewpoints. Rather, we wish to emphasize the *relative* power of compulsion provided in the parliamentary system.

It would be relatively more difficult to pass similar legislation in the United States for these commodities because of their narrow focus. The relative concentration of U.S. poultry production in the southeast insures a regional orientation. Passage of cartel-creating legislation that would primarily support specific commodities concentrated in a specific region would entail large trade-offs of support. This would be costly for legislators from the southeast.

The argument presented here implies, in contrast to the Stigler-Peltzman-Becker theory of interest group regulation, that political institutions do make a difference, at least insofar as they influence the cost of wielding political influence and the incentives to organize and seek such influence. Regionally concentrated commodity groups have obtained marketing arrangements in the United States, but their influence on prices through production regulation is generally less direct than in Canada. "Orderly marketing" through product quality restrictions and diversion of some production to secondary markets is utilized to affect product flows, but not the aggregate level of production. Other factors, such as organizing costs and demand elasticities, may entirely explain the policies that have evolved. Thus, the institutional considerations discussed here should be viewed as suggestions for further study. However, supply management of agricultural products has been prevalent in other parliamentary democracies such as Australia, New Zealand, and the United Kingdom. In nearly every case, the commodity interest groups are relatively small when compared with those in the United States, and therefore less costly to organize.

---

[13] We are not suggesting that American style pork-barrel politics does not exist in Canada. There is evidence that it does (MacNaughton and Winn 1981; Thompson and Stanbury 1984). Rather it appears that this type of behavior operates under different incentive structures and constraints due to the parliamentary system design.

There are no compelling reasons to suspect that the final two variables in equation 1 are substantially different between the United States and Canada. The importance of asymmetry (beyond geographic considerations) is difficult to ascertain. In both countries vertical integration in the poultry sectors is prevalent and industrial ownership and/or control of production is substantial. Unfortunately, data limitations and disclosure laws do not permit detailed analysis of this point. Furthermore, there is no obvious reason to suspect that nonpolitical benefits from organizing differ for Canadian and U.S. poultry farmers.

Finally, let us briefly consider the bureaucratic theory of regulation. Clearly, in its extreme form, wherein bureaucrats' interests alone determine the outcome of the regulatory process, this theory does not appear to provide a powerful explanation of the phenomena examined here. The inefficiencies created within the Canadian poultry sectors seem relatively small, at least as measured by deadweight losses. Additional inefficiencies may arise, of course, if, for example, the quota system leads to production by either inefficiently large or small producers given scale economies and diseconomies in these markets (see Benson and Faminow 1986, for examination of this potential source of inefficiency). Nonetheless, we cannot totally discount the potential for some bureaucratic influences, just as we cannot totally discount the role of government institutions. Supply management schemes appear to require relatively large bureaucracies to manage. Thus, supply management should be favored by budget maximizers, and Canada's agricultural bureaucracy is larger than that of the United States, relative to the size of the agricultural sectors of the two countries. When a regulatory system is favored by both powerful interest groups and members of the bureaucracy, one cannot say whose interests dominate. However, it is interesting to note that various government officials have tried to impose supply management on the beef cattle industry over the protests of those in the industry. This effort supports the assumption that bureaucrats *wish* to be budget maximizers, but its failure suggests that regulation's outcome cannot move very far from that desired by political interest groups.

Conclusion

This paper argues that an interest groups approach to policy helps explain the existence of supply management cartels in the Canadian poultry sectors. It is difficult to contend that supply management in these sectors can be defended on the basis of the public interest or other leading theories of regulation. The magnitude and direction of the transfers render such arguments unbelievable.

The transition of the interest group theory, largely developed on the basis of American experience, is not completely smooth, however. Differences in interest group characteristics and incentives may be sufficient to explain why, in the poultry sectors, we have cartelization in Canada and not in the United States, but differences in the structures of political institutions and the power of bureaucrats might also matter. Tentatively, it would appear that the political institutions inherent to each country affect the form and extent of agricultural policy intervention. It should also be noted that the reversal of the policies may be facilitated by the underlying political system. Whereas extended and costly campaigns are necessary to reduce U.S. agricultural transfers, parliamentary systems may be able to reverse previous policies quite quickly.

References

Becker, Gary S. "A Theory of Competition Among Pressure Groups for Political Influence." *Quarterly Journal of Economics* 98 (August 1983): 371–400.

Benson, Bruce L. "Why Are Congressional Committees Dominated by 'High Demand' Legislators?" *Southern Economic Journal* 48 (July 1981): 68–77.

Benson, Bruce L. "The Economic Theory of Regulation as an Explanation of Policies Toward Bank Mergers and Holding Company Acquisitions." *Antitrust Bulletin* 28 (Winter 1983): 839–62.

Benson, Bruce L. "Rent Seeking from a Property Rights Perspective." *Southern Economic Journal* 51 (October 1984): 388–400.

Benson, Bruce L., and Faminow, M. D. "The Incentives to Organize and Demand Regulation: Two Ends Against the Middle." *Economic Inquiry* (forthcoming, 1986).

Benson, Bruce L., and Greenhut, M. L. "Interest Groups, Bureaucrats and Antitrust: An Explanation of the Antitrust Paradox." In *Antitrust and Regulation,* pp. 53–90. Edited by Ronald E. Grieson. Lexington, Mass.: Lexington Books, 1986.

Borcherding, Thomas (with Gary W. Dorosh). *The Egg Marketing Board.* Vancouver: Fraser Institute, 1981.

Buchanan, James M., and Wagner, Richard E. *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press, 1977.

Clarkson, Kenneth W., and Murio, Timothy J. "Letting Competition Serve Consumers." In *Instead of Regulation: Alternatives to Federal Regulatory Agencies*. Edited by Robert W. Poole. Lexington, Mass.: Lexington Books, 1982.

Downs, Anthony. *An Economic Theory of Democracy*. New York: Harper and Row, 1957.

Eckert, Ross. "On the Incentives of Regulators: The Case of Taxicabs." *Public Choice* 14 (Spring 1973): 83–99.

Faminow, M. D., and Benson, Bruce L. "Rent Seeking and Supply Management in Canadian Agriculture." *Canadian Journal of Agricultural Economics* 32 (November 1984): 548–58.

Galbraith, John K. *Economics and the Public Purpose*. Boston: Houghton Mifflin Co., 1973.

Gardner, Bruce. *The Governing of Agriculture*. Lawrence, Kans.: Regents Press of Kansas, 1981.

Gardner, Bruce. "Efficient Redistribution Through Commodity Markets." *American Journal of Agricultural Economics* 65 (May 1983): 225–34.

Harling, Kenneth F., and Thompson, Robert L. "The Economic Effects of Intervention in Canadian Agriculture." *Canadian Journal of Agricultural Economics* 31 (July 1983): 153–76.

Henson, William L. "Broiler Production Costs in the Northeast," *Poultry and Egg Outlook and Situation*. U.S. Department of Agriculture, Economic Research Service, PES-313. May 1982.

Hilton, George. "The Basic Behavior of Regulatory Commissions." *American Economic Review* 62 (May 1972): 47–54.

Hirshleifer, Jack. "Comment." *Journal of Law and Economics* 19 (August 1976): 241–44.

Lermer, George, and Stanbury, W. T. "Measuring the Cost of Redistributing Income by Means of Direct Regulation." *Canadian Journal of Economics* 18 (February 1985): 190–207.

MacNaughton, Bruce D., and Winn, Conrad J. "Economic Policy and Electoral Self-Interest: The Allocations of the Department of Regional Economic Expansion." *Canadian Public Policy* 7 (Spring 1981): 318–27.

Mallen, Bruce. *A Preliminary Paper on the Levels, Causes and Effects of Economic Concentration in the Canadian Retail Food Trade: A Study of Supermarket Power*. Paper commissioned by the Food Price Review Board. Faculty of Commerce and Administration. Montreal: Concordia University, 1976.

McKenzie, Richard B., and Macauley, Hugh H. "A Bureaucratic Theory of Regulation." *Public Choice* 35 (1980): 197–313.

McManus, John C. "On the Efficient Design of an Agricultural Marketing Board." Department of Economics, Carleton University, April 1979.

Niskanen, William A. *Bureaucracy and Representative Government*. Chicago: Aldine Press, 1972.

Niskanen, William A. "Bureaucrats and Politicians." *Journal of Law and Economics* 18 (December 1975): 617–43.

Nore, Petter. "The State." In *Economics: An Anti-Text*. Edited by Francis Green and Petter Nore. London: Macmillan and Co., 1977.

Olson, Mancur. *The Logic of Collective Action*. Cambridge: Harvard University Press, 1965.

Peltzman, Sam. "Toward a More General Theory of Regulation." *Journal of Law and Economics* 19 (August 1976): 211–40.

Posner, Richard. "Theories of Economic Regulation." *Bell Journal of Economics and Management Science* 5 (Autumn 1974): 335–58.

Russell, Milton, and Shelton, Robert. "A Model of Regulatory Agency Behavior." *Public Choice* 20 (Winter 1974): 47–62.

Schmitz, Andrew. "Supply Management in Canadian Agriculture: An Assessment of the Economic Effects." *Canadian Journal of Agricultural Economics* 31 (July 1983): 135–52.

Skogstad, Grace. "The Farm Products Marketing Agencies Act: A Case Study of Agricultural Policy." *Canadian Public Policy* 6 (Winter 1980): 89–100.

Spitze, R. G. F. "The Food and Agriculture Act of 1977: Issues and Decisions." *American Journal of Agricultural Economics* 60 (May 1978): 225–35.

Stigler, George J. "Free Riders and Collective Action: An Appendix to Theories of Economic Regulation." *Bell Journal of Economics and Management Science* 5 (Autumn 1974): 359–65.

Stigler, George J. "The Theory of Economic Regulation." *Bell Journal of Economics and Management Science* 2 (Spring 1971): 3–21.

Thompson, Fred, and Stanbury, W. T. "Looking Out for No. 1: Incumbency and Interest Group Politics." *Canadian Public Policy* 10 (June 1984): 239–44.

Tollison, Robert D. "Rent Seeking: A Survey." *Kyklos* 35 (1982): 575–602.

Veeman, Michele M. "Social Cost of Supply-Restricting Marketing Boards." *Canadian Journal of Agricultural Economics* 30 (March 1982): 21–36.

Weingast, Barry R., and Moran, Mark J. "Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission." *Journal of Political Economy* 91 (October 1983): 765–800.

Wilson, James Q. *The Politics of Regulation*. New York: Basic Books, 1980.

TARGETED CAPITAL SUBSIDIES AND ECONOMIC WELFARE

Gary Fournier and David Rasmussen

I. Introduction

Both federal and state government agencies are actively involved in programs designed to reduce the cost of capital to specific targeted groups of firms or individuals. At the federal level alone, there has been a rapid rise in the use of credit subsidies to achieve various public policy goals. According to a recent report of the General Accounting Office (GAO 1983), new direct loan obligations of the U.S. government increased from $10.5 billion in fiscal year 1971 to $57.2 billion in 1981, while new commitments for guaranteed or insured loans rose from $38.5 billion to $76.5 billion. By 1982 some 424 credit programs and activities were authorized by law, including both on-budget and off-budget programs of 27 departments and independent agencies. The level of direct loans outstanding in 1981 totaled $185 billion, having increased 250 percent in 10 years. To put these GAO figures in the context of aggregate credit flows, federal loans and loan guarantees in 1981 accounted for 33 percent of the total funds raised in credit markets by nonfinancial sectors for the year (Council of Economic Advisers 1983, pp. 236–37).

One group often singled out for subsidies are business enterprises with characteristics targeted under criteria established by policymakers. Although they comprise a relatively small component of the overall government credit activities, business capital subsidies are particularly interesting to economists both because they represent attempts to change the allocation of investment in the economy as a whole, and because they seek to weaken the market test of firm survival. These programs take a variety of forms: a government agency

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

Gary Fournier is an Assistant Professor and David Rasmussen a Professor in the Department of Economics at Florida State University.

may provide direct loans, or it may make simple cash payments to private lenders to cover a portion of the interest cost of the loan, or it may only assume liability to repay the loan if the borrower defaults. Regardless of how the government participates in a loan transaction, the effect is to reduce the interest rate below what the firm would otherwise pay.

In section II we identify some of the rationales for providing business capital subsidies and argue that support for these programs rests on popular beliefs that public interest benefits are created by facilitating access to capital for particular firms. Yet, for the most part, the exact nature of these public interest objectives and the effectiveness of subsidy programs in achieving them remains obscured from public debate. Section III points out some generic problems in implementing capital subsidies, which serve to show that these programs do not always bear a reasonable relation to the objectives sought. We discuss in section IV a further set of unique problems raised by conflicting interests among levels of government.

II. Public Interest Rationales for Capital Subsidies

What specific objectives are business capital subsidies intended to accomplish? How do legislatures and executive agencies justify the use of these costly policy instruments? Public hearings are often vague on these questions, as politicians seem unwilling or unable to articulate precisely what economic conditions necessitate government action in the credit markets. Furthermore, special interest legislation may well lie at the root of why government engages in such programs. Indeed, the intended recipients of a particular program may be a different interest group from what is declared in rhetorical political discussions. Recent literature on the political economy of regulation provides ample illustrations of programs in which transfers wound up in the "wrong place."[1]

---

[1] Several examples can be used to illustrate the notion that transfers end up in the wrong place. While the Robinson-Patman Act is one area of antitrust in which the government is seen as promoting or protecting small business, there are other hidden beneficiaries. Recent studies (see, for example, Ross 1984) show that major benefits under the act were reaped by other industry groups, such as the large food wholesalers and the food brokers. Similarly, the FCC's attempt to promote UHF broadcasting through implicit subsidies and regulatory protections is ostensibly an attempt to promote local enterprise in TV, and yet the major benefits of regulation accrued to a different segment of the industry, especially the VHG network-affiliated stations in large cities and certain other factors of production (Crandall 1978; Fournier 1985). Airline deregulation has shown that a sizable portion of the potential rents created under CAB rule were dissipated through nonprice competition among carriers, with the remainder extracted by airline pilots and other factors of production rather than by the carriers themselves (see, for example, Bailey et al. 1985, pp. 91–110; Moore 1982).

While recognizing at the outset that a discussion of public sector decision making of the sort just described is important in a broader perspective, our analysis examines the "market failure" aspects of credit activities and addresses the problem of when, if ever, there might be defensible public interest objectives at which these government activities are directed.

Business capital subsidies at the state and local level are most frequently justified in terms of their potential for generating jobs in a specific area; their net impact is of little relevance to program assessment. At the federal level, job creation policies are in the domain of macroeconomic policy, and capital subsidies are justified by their ability to remedy four substantive problems in the allocation of capital resources. First, policies may be employed as part of the overall strategy to alter the distribution of wealth or income in desirable ways. Second, subsidies for capital may be intended to compensate for capital market imperfections that foreclose access or discriminate against identifiable groups of business enterprises. Third, the policy goal of promoting competition might be furthered with capital subsidies designed to offset barriers to entry. Finally, the desirability of these policies might be attributed to perceived externalities in private sector investment. For instance, capital subsidies might be seen as a direct incentive for businesses to expand politically favored activities, such as pollution control or energy conservation. Each of these rationales will be discussed in turn.

Enhancing Overall Income Distribution

Transfers to enterprises may be designed to promote changes in the distribution of wealth or income in society. It is certainly true that some individual business owners can be made wealthier by programs subsidizing their cost of capital. And, while benefits to specific individuals need not translate into general benefits to targeted groups of disadvantaged persons, programs of this nature are most often seen as part of the overall plan to relieve the economic distress of lower income groups. The expectation might be that the subsidies will stimulate the hiring and training of disadvantaged groups. In addition, subsidizing minority business might have a broader "demonstration" effect beneficial to the perceived economic opportunity of minorities, especially when programs facilitate entry into industry by minorities.

Correcting Capital Market Imperfections

A second justification for capital subsidies rests on the premise that certain worthy investors are denied equal access to capital.

Capital market imperfections that foreclose access to investment capital or otherwise discriminate against particular enterprise groups, especially small firms, might be corrected if these groups can be successfully targeted. The severity of capital market imperfections is highly controversial. There is some empirical evidence for imperfections in that the risk adjusted rate of return is higher for small firms than for large firms (Banz 1981; Reinganum 1981). Whatever merit exists in the argument, there are strong indications that public policy perceives the problem as real. For example, Congress, in creating the Small Business Administration (SBA), instructed it to "study the ability of financial markets and institutions to meet small business credit needs," and "to determine financial resource availability and to recommend methods for delivery of financial assistance to minority enterprises, including methods for securing equity capital."[2] This mission contemplates an active response—a policy of capital subsidies—only if capital markets are judged deficient.

Promoting Competition in the U.S. Economy

Another objective of these programs is to make the economy more competitive. Where past discrimination against minorities, women, or small enterprises has erected barriers to entry into a broad range of industries, capital subsidies may be viewed as attempts to remove those barriers. The objective is thus to raise the proportion of all industry that is effectively competitive. If discrimination had taken the form of credit rationing or price discrimination on loans to the disadvantaged groups, capital subsidies attack the barrier to entry at its source. But, more generally, if past discrimination has ubiquitous effects on technical, organizational, or entrepreneurial abilities of minority enterprises, capital subsidies are akin to "infant industry" protections in international trade. Temporary subsidization provides these firms an opportunity for learning by doing, one that would not be available from private venture capitalists or other channels of finance. The arguments for subsidization have to be carefully qualified, since the inherent tendency of infant industry protections to perpetuate inefficiency is well documented (for example, Yeager and Tuerck 1966, pp. 217–22; Lindert and Kindleberger 1982, pp. 145–47).

That a prime objective of policy is to promote competition and economic opportunity is readily seen. The SBA, for example, is charged with examining "the contribution which small business can make in improving competition, encouraging economic and social mobility for all citizens . . . expanding employment opportunities . . . [and]

---

[2] 15 U.S.C. 634.

providing an avenue through which new and interesting products and services can be brought to the marketplace." Further, the essence of SBA's function is to "recommend specific measures for creating an environment in which all businesses will have the opportunity to compete effectively and expand to their full potential."[3]

Compensating for Positive Externalities

Where the presence of externalities leads to underinvestment by the private sector, relative to what is socially optimal, programs subsidizing capital might be remedial to the extent that they raise the private perceptions of returns to investment. The point is particularly applicable to programs geared to spatial distress, as observed in the aging and decay of certain urban areas. Here, it might be argued that profit streams generated by private redevelopment fail to reflect a substantial portion of the social benefits. Alternatively, if investment depends on well-functioning capital markets, market failures in which investors are unable to diversify risk or otherwise arrange optimal risk sharing may pose a stumbling block to correcting spatial disequilibria. Capital subsidies, in one sense, act to negate imperfections created by other government policies, such as bankruptcy laws.

The government, with its power to spread risks widely and without much consent, is in a unique position approaching "risk neutrality." Given the relatively low risk premium attached to government securities, levels of investment might be stimulated where government shoulders a large portion of the risk (Arrow and Lind 1970).[4] It does not follow that having more investment is necessarily efficient, since the low cost of capital facing the government is only a "pecuniary" economy. But if the reallocation of risk generates real economies, as when it corrects a positive externality, there is potential for efficiency gains.[5] The same argument applies to emergency or disaster relief loans: government intervention acts as a buffer to sudden shocks in the capital markets when natural disasters produce unanticipated demand for net investment by large and diverse groups of enterprises. A final illustration is the use of capital subsidies to create economic incentives for investment in politically favored activities, such as energy conservation or pollution control. Even if a strong political consensus favors energy conservation, the private level of investment may fail to reflect perceived external benefits.

---

[3] 15 U.S.C. 634(b)(1); 15 U.S.C. 643(b)(9).

[4] This argument can only be applied where the government's cost of pooling is less than that of private financial intermediaries and other corporations. AAA bonds typically pay interest rates very close to those paid by state governments, which would seem to rule out all but the federal government. Likewise, the movement toward conglomerate enterprises is partly a response to risk-spreading and pooling advantages of mega-product enterprises. The federal role in risk pooling would therefore seem to be most relevant in the context of smaller firms.

[5] The default record of the SBA may indicate that the private risk assessments were correct. As an empirical proposition, perhaps one could test whether government credit programs generate real economies by comparing the default rates between SBA loans with those generally observed for a suitable comparison group in the private sector. A one-tailed test would reject this hypothesis where a higher proportion of defaults on federal loans is found, despite the subsidized interest rate. Investment projects that cannot even make it under those constraints are arguably extra-marginal. A more complete analysis would have to assess the dynamic effects on innovation as well.

III. Welfare Effects of Federal Capital Subsidies

We have identified a wide range of arguments used to justify business capital subsidies as being in the public interest. Even if one tentatively accepts these objectives at face value, it remains for us to consider what economic effects are associated with these policy instruments. Are the objectives sought in these programs likely to be achieved? Does it matter if the programs generate windfalls to unintended beneficiaries? What hidden costs are being borne by society? Finally, does our analysis suggest anything to policymakers about pitfalls to be avoided in the design of these programs? We discuss these questions in the context of a set of generic problems associated with capital subsidies. These problems include induced rent-seeking responses; the inability of policy to confine benefits to targeted groups; the effects of programs on the allocation of investment capital; and principal-agency problems associated with the administrative process.

Rent-Seeking Responses to Subsidy Programs

A major problem is created when subsidy programs give rise to rent seeking. James Buchanan (1980, p. 4) defines this phenomenon as "behavior in institutional settings where individual efforts to maximize value generate social waste rather than social surplus." Some rent seeking would be naturally generated by the very nature of the allocation process determining which firms receive subsidies. Expenditures in the form of management time, consulting services, and legal representation frequently become necessary inputs to administrative decision making. Capital subsidy programs that provide benefits to only a portion of the eligible enterprises or programs where there is a rationing problem can generate rivalrous legal contests that dissipate some of the program's benefits. Each risk-neutral enterprise will incur the expense of rent-seeking activities if it expects a sufficiently favorable increase in the probability of being awarded the subsidy, that is, if the activities raise the present value of expected benefits by more than their cost. Since the resulting contest is characteristically a negative-sum game, rent-seeking expenditures could easily equal or exceed the value of the subsidy (see, for example, Tullock 1980; Davis and Meyer 1969).

How much waste is generated in the form of rent-seeking activities depends on characteristics of the firms participating and the programs themselves. Some circumstances favor rent seeking more than others. For example, if a program targets small firms that are short of capital one might expect that these enterprises have a comparative disadvantage in rent-seeking activities, deriving from their high marginal cost (relative to large firms) of diverting managerial resources and working capital away from their primary line of business.[6] In contrast, capital subsidies rationed among relatively prosperous firms with adequate capital are likely to generate considerably more competition in light of their opportunity costs. In brief, if there are economies of scale in carrying out acts of persuasion before administrative bodies, large firms will engage in rivalries more often than small firms. The assumption that large profitable firms have advantages over small firms seems plausible,[7] but the concept that some circumstances favor rent seeking more than others extends to any firm characteristic yielding comparative advantage in lobbying or political activity.

An important concern is with a particular form of rent seeking, which might be called defensive or preemptive rent seeking. Defensive rent seeking occurs when a firm tries to prevent an actual or potential competitor from receiving a subsidy to avoid being put at a competitive disadvantage or simply to raise the cost of entry. Existing firms may correctly perceive that new competition will potentially damage their profitability, and thus they will expend resources to avert the capital subsidy in order to protect their market share or profits. Even if the market is competitive and all firms face identical costs, defensive rent seeking may be the only alternative to exiting from the market. In such a case, the subsidy program would merely cause a replacement of one firm by another. One might complain that the program only serves to build up the social costs of entry and exit by causing unnecessary turnover among firms. This problem is especially visible under programs involving retail services in local markets, such as hotel and restaurant franchises vying for industrial revenue bonds. These expenditures and related social costs should be subtracted from the social benefits attributed to the subsidy programs.

---

[6] Of course, a well-functioning market system would provide intermediaries to represent small firms before the administrative agency in exchange for a portion of the expected benefit, but whether such services do become available is uncertain and subject to substantial transaction costs. To illustrate, the proliferation of trade associations in Washington can be seen as a means for small firms to participate in rent-seeking activities that would be impossible otherwise.

[7] It is well known that large firms have superior access to law in civil litigation, and the same is likely to apply to rent seeking. The ability to obtain and retain effective legal representation is greater among large firms. Rent seeking is an activity subject to multiplant economies of scale, since it involves functions and expenditures that do not vary directly with the level of the firm's output. If there are lump-sum components that the firm must treat as sunk costs, large firms will be more likely than small ones to view the activity as attractive.

The Targeting Problem

A recent report on business capital subsidy programs found that 81 percent of over 300 federal programs surveyed were targeted to specific types of firms (Levinson et al. 1982). These programs, therefore, deliberately attempt to restrict the benefits to particular enterprise groups. Among these are "industry" groups, such as firms in fishing, mining, energy, and transportation, "small businesses" as might be defined by various size standards, and "spatially-targeted" firms located in areas of economic distress.

The feasibility of targeting is problematic. What will determine whether the individual firm being awarded special treatment is going to be made better off? Can the government successfully target its intended recipient group? We have already hinted at one reason for questioning the premise that the dollar passes directly from origin to target, namely, the possibility of rent seeking. Now we develop the argument further.

At the outset, the question of targeting is related to the standard public finance issue of the incidence of an excise tax or subsidy (see, for example, Shoup 1974). Merely providing firms with a per-unit cash subsidy does not ensure that they will profit from it. In competitive industries price adjustments pass on part of the benefit of a subsidy to consumers. In particular, the benefits are divided between consumers and producers in proportion to the ratio of market supply elasticity to market demand elasticity, measured at the initial equilibrium. Thus, if supply is highly elastic, relative to demand, attempts to make minority firms better off may largely subsidize a totally different socioeconomic group of consumers.

Other sources of "leakages" are the factors of production in the targeted firm. Generally, whatever producer surplus is retained by the firm will be passed on to specialized factors of production. Especially in small businesses where employees acquire a high component of firm-specific human capital, and where compensation is determined through bilateral bargaining, the employees may regard capital subsidies as "appropriable quasi-rents" (Klein, Crawford, and Alchian 1979).

The problems inherent in targeting, however, go beyond that of incidence. The most critical obstacle is the difficulty in choosing an appropriate definition of the target group. Ideally, policymakers have in mind a distinction between "deserving" and "undeserving" firms, but this distinction is no easier in practice than separating the "deserving" poor from the "undeserving" poor in welfare programs. Even if one believes, for example, that small firms are subject to credit rationing or discrimination, the choice of an appropriate size threshold is likely to produce unintended beneficiaries. Apart from the where-you-draw-the-line problem, there is the difficulty of filtering out firms meeting size standards but undeserving of subsidy. Credit programs, recognizing the existence of undeserving applicants, may compound the problem by adopting behavioral restrictions, such as requiring evidence that the firm's loan application has been turned down by local banks.

Any attempt to define a suitable recipient pool will be subject to two types of errors. In the parlance of statisticians, "type one" errors occur when the agency fails to provide assistance to a firm that is truly deserving, given the spirit and intent of the program. "Type two" errors occur when the agency has wrongly subsidized a firm that does not deserve such assistance. Whether agencies will adopt decision rules that weigh correctly the costs and benefits of decisions subject to these errors is difficult to gauge without reference to the bureaucrats' incentives and constraints. The costs associated with the second type of error involve hidden and dispersed economic inefficiencies that are unlikely to be traced back to the bureaucrat. Thus, we might expect biases to be in the direction of programs that reach beyond the pool of deserving or disadvantaged enterprises.

A final factor to consider about targeting particular firms is that any attempt will be met by strategic, opportunistic responses by firms attempting to avail themselves of the benefits. Subsidy programs targeted to sex, racial, or ethnic minorities with a specified ownership threshold, say 51 percent, may lead to deliberate forms of ownership restructuring in limited partnerships and corporations, as firms seek to qualify. Similarly, programs earmarked for small businesses based on thresholds of size may lead to production at below minimum efficient scale to the extent that the private profits from operating as a small inefficient (but subsidized!) firm are greater than the profits the firm could achieve at minimum efficient scale without subsidy. Ronald Coase's (1937) theory of the firm suggests that the organization of production within a firm reflects a balancing of the net profits, at the margin, of in-house operation with the alternative of interfirm market transactions. For instance, extensive provision of small business subsidies may bias the retail distribution system in the direction of franchising, and away from vertically integrated provision of goods and services, even in the presence of economic efficiencies that might dictate the opposite organization.

In sum, there are substantial reasons to doubt the ability of federal agencies administering capital subsidy programs to target successfully any particular group of firms that might be singled out under the public interest objectives mentioned earlier. The distribution of benefits bears little resemblance to our intuitive notions of deserving or disadvantaged members of society. And the associated allocative problems are potentially large, especially since they appear in places unlikely to alert the attention of administrators.

Misallocation in Capital Markets and Related Effects

The function of capital markets in allocating investment funds is well understood (see, for example, Stiglitz 1982). Among other things, capital markets assimilate information regarding credit risks and determine risk premia attached to competing demands for investment funds. When government intervenes to alter this allocation mechanism, it is presumed that some market imperfection is present. The monopoly power of banks was formerly considered a significant imperfection in capital markets, especially for small firms that must rely on bank loans as their primary source of finance. But such arguments have been severely eroded by recent developments in the deregulation of financial institutions.

Alternatively, capital market imperfections in the form of denial of credit might be caused by institutional obstacles to market-clearing loan contracts, as with usury laws or the inability of lenders to enforce high interest rate contracts in courts. Also, it might be argued that the apparent market efficiency is conditioned on a given information set, while nothing ensures that public goods problems associated with the production of information will be overcome by the profit motive of investment analysts.

Are capital markets then truly efficient? What some observers regard as a market failure others would see as evidence of a smooth functioning market. For example, when certain demanders of capital are systematically discriminated against, it could be claimed that the market is simply internalizing transaction costs and risk assessment into its allocation decisions in an optimal fashion. After all, it is efficient for private suppliers of capital to deny funds to an enterprise that appears too risky because of its location, size, or demographic characteristics of its owners. The case for capital subsidies rests on a belief that, even if the market were operating efficiently from this private perspective, the operation of the capital market may be failing if society could realize a higher rate of return with some sort of intervention that allocated capital differently.

The danger is that in the process of allocating capital "differently," government programs sacrifice some market information essential to risk assessment. There are at least two reasons for expecting this result. First, government agencies have less incentive for evaluating credit-worthiness in rationing available funds, because they do not shoulder the consequences of bad judgments, and because credit-worthiness is antithetical to the programs being administered. Indeed, there is usually an explicit requirement that the applicant establish its inability to obtain private financing. Second, it is not obvious that business capital subsidy programs will substantially increase the total savings or investment in the economy. Without increasing the supply of funds, there must be a change in the mix of investments, as some projects are crowded out in lieu of others that are subsidized. Therefore, these programs carry the opportunity cost of diverting funds from marginal investment projects.

The Agency Problem

The problem of policing an agent to enforce actions in the principal's interest is well known. Although this problem is not trivial in any private or government activity, it is acute in the capital subsidy programs that attempt to raise the social rate of return on investment. We argue that agency problems raise serious doubts about the potential effectiveness of public sector attempts to improve the allocation of investment.

The contrast between private market allocation of investment and its governmental counterpart is striking. Agents acting on behalf of private financial institutions are subject to competitive forces holding them accountable for the consequences of portfolio management decisions. The dramatic improvements in recent years in the competitiveness of the markets for investment funds limit the exercise of discretion by private agents. With the threat of takeover or market displacement, the private manager has an incentive to invest efficiently in information relevant for assessing the risk-return profile of potential borrowers. Moreover, inefficient (or unlucky) managers can be weeded out because their performance evaluation is relatively uncomplicated. The government agent, in contrast, is largely insulated from these forces and faces an entirely different set of incentives and constraints.

Consider the example of the small business venture capital programs sponsored by state governments. As of 1981, 10 states had established quasi-independent or private corporations with a venture capital orientation, the most prominent being the Connecticut Product Development Corporation and the Massachusetts Technology Development Corporation. In total, state venture capital programs allocated about $31.2 million in 1981 (NASDA et al. 1983).

The usual goal of these state programs is net job creation, which we understand to mean the creation of more jobs than would have been generated in the absence of the program. A state agency administering such a program would no doubt be evaluated in terms of its apparent success, and failed investments detract from such an assessment. Hence, agency administrators will have an incentive to support the safest possible investments, since risk taking raises the probability that some projects will fail and thus threatens the job security of agency staff. Depending on the budget and other constraints imposed externally, the staff might even adopt the strategy of supporting firms that would have been funded by the private sector anyway. If investment risk taking was truly in the intended spirit of the program, such agent decision rules will reduce the program's effectiveness. Second, the goal of creating jobs biases the agency in favor of labor-intensive ventures, unless they receive credit for multiplier effects.

These problems are not easily solved by privatizing the activity or by setting up a quasi-public corporation dedicated to venture capital investments that create jobs. In either of these cases, the evaluation of the agent or manager is likely to rest on imperfect criteria, such as the number of jobs created by investments in the corporation rather than correct but elusive measures of *net* job creation. Naturally, the agents will be motivated to enhance their own performance evaluation and will therefore attempt to avoid the failures that would inevitably accompany a portfolio that is not explicitly risk averse. Hence, the process of accountability will create an agency problem irrespective of the way a supposed risk-neutral investment fund is organized.

To summarize, business capital subsidies are subject to several types of problems that need to be thoughtfully considered when assessing their potential use as policy instruments. We conclude the following:

1. In certain circumstances rent seeking will be a substantial source of socially wasteful activity induced by these programs.
2. Successful targeting of particular groups of firms for receipt of benefits is difficult to achieve.
3. Capital subsidies may contribute to inefficiency in the allocation of investment funds.

4. It is unreasonable to assume that the incentives of government agents and administrators will be adequate to restrict their pursuit of objectives in conflict with the goals of the programs.

IV. State and Local Capital Subsidy Programs

Parochial state and local interests are served equally well by capital subsidy programs that pirate jobs from other areas or create net new employment.[8] Thus, state and local capital subsidies can be successful without contributing to the solution of any of the alleged resource allocation problems that motivate federal programs. In this section we explore the possibility that state programs could be substituted for federal efforts when capital subsidies are thought to further some national purpose.

State capital subsidy programs are not immune from the problems that plague the effective implementation of federal efforts. For example, targeting is a substantial problem because capital subsidy programs administered by state and local governments produce geographically dispersed benefits. This inevitable dispersion of benefits is a straightforward consequence of the free flow of interstate commerce. Suppose, for example, a state or local government subsidizes some capital investment projects for redevelopment of a distressed area. Although the funding jurisdiction pays 100 percent of the costs, the employment and economic activity generated by the expenditures would be dispersed over many states due to the interdependence of domestic markets.

The efficacy of these incentives from the state's fiscal perspective is further compromised by the federalist nature of the U.S. tax system. It can be shown that the federal government benefits through higher tax revenues when state and local governments subsidize capital to firms (Rasmussen et al. 1984).[9] In particular, when state capital subsidies increase corporate profits, this translates into an increased federal corporate or income tax liability. Through this avenue, state-funded capital subsidy programs implicitly subsidize the federal government.[10]

---

[8] State and local governments subsidize the cost of capital by a myriad of programs that feature direct loans, interest subsidies, loan guarantees, quasi-independent and private capital corporations, and industrial revenue bonds. The composition of these incentives was revealed in an exhaustive survey of state and local economic development incentives conducted by the Urban Institute and the National Association of State Development Agencies (NASDA et al. 1983). The survey shows that in 1981 these governments influenced the allocation of about $19.8 billion through such programs, or approximately 5 percent of gross private domestic investment for that year.

[9] There are certain "general equilibrium" limitations to this analysis. The analysis works if states increase the number of projects, or the value of net investment, in the aggregate; that is, when the states are able to select projects yielding higher rates of return than the free market, or when government-subsidized projects are of the high risk, high return variety that are likely to be denied access to private funding. Only if these types of profit-creation results occur, do the aggregate profits and tax yield of the treasury

An obvious solution to the dispersed benefits problem is to have the federal government fund a program administered by state or local governments. This solution is not without its pitfalls. Industrial revenue bonds (IRBs) are issued by state and local agencies and funded by the federal government via a tax expenditure because the subsidy arises from preferential tax treatment of interest earned on the bonds. Considering that the state allocates the bonds while the federal government pays the cost, IRBs are highly cost effective from the state's perspective. Except for recent attempts to control the volume of IRBs offered, this program has long been operated in a way that encouraged unconstrained use, since state and local jurisdictions were given a "capital subsidy credit card" that never had to be paid off.

This solution to the dispersed benefits problem—to give the localities control over the distribution of federally funded benefits—simply created an inefficient program with a substantial free-rider problem. According to Rasmussen et al. (1984), the IRBs are the least efficient of all capital subsidy programs from the combined perspective of all levels of government. It is not surprising that the IRB program would come to dominate all other programs. The 1981 total volume of state and local capital subsidies was $19.8 billion. Of this total, federally funded IRBs accounted for $19.4 billion (NASDA et al. 1983). Hence, state and local governments committed only modest amounts of their own resources to capital subsidies, amounting to about 2 percent of the total expenditures.

To the extent that some existing capital subsidy programs merit retention, our analysis suggests that the federal government must be responsible for their funding. States are not well suited to finance programs associated with dispersed benefits. Yet it is possible that states have a comparative advantage in the administration of the programs. Perhaps a desirable arrangement would be to retain the financial responsibilities for these programs in the federal government, but to utilize state administration, provided that the adminis-

---

become enhanced. If savings are fixed, the reallocation of investment projects causes a reduction in total profit taxes since the subsidy eliminates investments yielding relatively higher returns.

[10] State interest subsidy programs are not cost effective in that it costs the state as much as $182 to deliver $100 benefit to a firm (Rasmussen et al. 1984). Although state loan guarantee programs are more cost effective in this sense, the result is highly sensitive to the assumed default rate.

trative units are given specific budget constraints instead of unconstrained tax preferences.

V. Conclusion

We have enumerated several public interest objectives presented to justify the use of targeted business capital subsidies. The list is noteworthy in that it includes goals, such as income redistribution and antidiscrimination, that permeate public policy in other areas, including welfare, health care, and education. Typically, capital subsidies are cloaked in multiple public purposes: a program for small businesses may be intended to provide economic opportunity to minorities, promote competition, and create employment in a distressed area. In some cases, the goals reflect premises about the economy ("capital markets are imperfect"; "small firms foster a more rapid rate of innovation"). These premises can be tested in principle with scientific methods, and are thus contingent on current knowledge. In other cases, the goals represent normative values ("the steering of investment toward politically favored purposes is desirable").

While no purpose is served in trying to refute the values reflected in the goals we identify for these programs, there is a reasonable basis for expecting that implementation problems will undermine policy effectiveness. Even if public interest goals are widely shared and truly represent the motivation for having business capital subsidies, are they the best way to achieve these goals? Quantitative program evaluations (or cost-benefit analysis) might help to reveal whether these programs achieve acceptable performance.[11]

A correct evaluation of these programs requires attention to their hidden and indirect ramifications. We have suggested some generic problems that arise from the rational responses of individuals, and their collective expression in markets, to the incentives created by these programs. The importance of these considerations will vary with the context. Contrast the problems associated with programs aiding small businesses with those in programs for emergency relief. When the targeted firms are small, there are likely to be few rent-seeking activities; but our ability to confine the benefits to appropriate recipient groups is severely limited. Especially when the participating firms operate in competitive output markets, the benefits will be largely captured by consumers or negated by exit of a nonsubsidized firm. The exiting firm may indeed be from the same minority group in the distressed area. These problems are much less evident in capital subsidies for emergency relief, since there is no long-term program that rent seekers can attempt to manipulate nor ambiguous goals that could create a severe agency problem. Looking further at programs aimed at revitalizing urban areas, we find that they inevitably involve participation of large firms operating in highly competitive markets, posing a likely threat to some existing firms. Hence, we encounter the difficulty of targeting, rent seeking, defensive rent seeking, and a possible misallocation of capital.

---

[11] Policy formulation regarding these programs is hindered by the lack of information being generated within the government about these programs, their benefits and costs, reach and distribution. A congressional staff report laments, "we know little or nothing about the benefits from these subsidy programs and who gets them. Our knowledge about what these programs cost the government and what adverse effects they have on the economy is quite limited" (U.S. Congress, Joint Economic Committee 1974). The lack of information with which to assess the impact of credit programs on the allocation of investment capital is particularly troublesome. Moreover, the same report suggests that cost may not be Congress's primary consideration when enacting or extending programs of this kind, or for executive agencies managing them.

Whether targeted business capital subsidies are an effective means of redistributing income is a function of two opposing factors. First, compared to equivalent cash transfers, subsidies produce additional allocative inefficiencies. When the subsidies work by changing the relative prices of the factors used by the firm in production, participation in these programs results in inefficient input selection. In addition, subsidies are likely to change the relative prices of subsidized and nonsubsidized final goods, causing further allocative distortions. There may also be social costs in the form of rent seeking, excessive firm turnover, or principle-agent distortions. Second, the normative desirability of redistribution, as viewed by some members of society, is enhanced because the subsidy requires the recipient to engage in some productive enterprise. Yet, as we have argued, our ability to redistribute income by these programs might be undermined when the benefits are extracted largely by economic agents other than the owners of the subsidized firms. If income or economic opportunity is the goal, it is perhaps more cost effective simply to offer some deserving recipient a fellowship to the Harvard Business School.

References

Arrow, Kenneth, and Lind, Robert. "Uncertainty and the Evaluation of Public Investment Decisions." *American Economic Review* 48 (June 1970): 364–78.

Bailey, Elizabeth; Graham, David; and Kaplan, Daniel. *Deregulating the Airlines*. Cambridge: MIT Press, 1985.

Banz, Rolf. "The Relationship between Return and Market Value of Common Stocks." *Journal of Financial Economics* 9 (March 1981): 3–18.

Buchanan, James. "Rent-Seeking and Profit Seeking." In *Toward a Theory of the Rent-Seeking Society*, pp. 3–15. Edited by James Buchanan, Robert Tollison, and Gordon Tullock. College Station, Tex.: Texas A&M University Press, 1980.

Coase, Ronald. "Nature of the Firm." *Economica* 4 (1937): 386–405.

Council of Economic Advisers. *Economic Report of the President*. Washington, D.C.: Government Printing Office, February 1983.

Crandall, Robert. "Regulation of Television Broadcasting: How Costly Is the Public Interest?" *Regulation* 2 (January/February 1978): 31–40.

Davis, J. Ronnie, and Meyer, Charles. "Budget Site in Democracy." *Southern Economic Journal* 36 (July 1969): 10–17.

Fournier, Gary. "Nonprice Competition and the Dissipation of Rents from Television Regulation." *Southern Economic Journal* 51 (January 1985): 754–65.

Klein, Benjamin; Crawford, Robert; and Alchian, Armen. "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process." *Journal of Law and Economics* 21 (October 1978): 297–326.

Levinson, Phyllis et al. *The Federal Entrepreneur: The Nation's Implicit Industries Policy*. Washington, D.C.: The Urban Institute, April 1982.

Lindert, Peter, and Kindleberger, Charles. *International Economics*. 7th ed. Homewood, Ill.: Richard D. Irwin, 1982.

Moore, Thomas Gale. "Reagulation—The First Year: Transportation." *Regulation* 6 (January/February 1982): 27–29.

National Association of State Development Agencies, National Council on Urban Economic Development, and The Urban Institute. *Directory of Incentives for Business Development and Assistance in the United States: A State-by-State Guide*. Washington, D.C.: The Urban Institute Press, August 1983.

Rasmussen, David; Bendick, Marc; and Ledebur, Larry. "A Methodology for Selecting Economic Development Incentives." *Growth and Change* 15 (January 1984): 18–25.

Reinganum, Marc. "Misspecification of Capital Asset Pricing." *Journal of Financial Economics* 9 (March 1981): 19–46.

Ross, Thomas. "Winners and Losers Under the Robinson-Patman Act." *Journal of Law and Economics* 27 (October 1984): 243–71.

Shoup, Carl. "The Economic Theory of Subsidy Payments." In *The Economics of Federal Subsidy Programs*, Part 1. U.S. Congress Joint Economic Committee, 92nd Congress, 2d sess. Washington, D.C.: Government Printing Office, 8 May 1972.

Stiglitz, Joseph. "Information and Capital Markets." In *Financial Economics: Essays in Honor of Paul Cootner*, pp. 118–58. Edited by William Sharpe and Cathryn Cootner. Englewood Cliffs, N.J.: Prentice Hall, 1982.

Tullock, Gordon. "Rent Seeking as a Negative-Sum Game." In *Toward a Theory of the Rent-Seeking Society*, pp. 16–36. Edited by James Buchanan, Robert Tollison, and Gordon Tullock. College Station, Tex.: Texas A&M University Press, 1980.

U.S. Congress. Joint Economic Committee. *Federal Subsidy Programs*. Staff Report, 93rd Congress, 2d sess. Washington, D.C.: Government Printing Office, 18 October 1974.

U.S. General Accounting Office. *Catalog of Federal Credit Programs and Their Interest Rate Provisions*. Staff Report, GAO/PAD-83-12. Washington, D.C.: Government Printing Office, 28 December 1982.

Weidenbaum, Murray. *Business, Government, and the Public*. 2d ed. Englewood Cliffs, N.J.: Prentice Hall, 1983.

Yeager, Leland, and Tuerck, David. *Trade Policy and the Price System*. Scranton, Pa.: International Textbook, 1966.

CAPITAL SUBSIDIES, CAPITAL ALLOCATION, AND ECONOMIC WELFARE

J. Ronnie Davis

The paper by Gary Fournier and David Rasmussen (1986) points to the importance of analyzing business capital subsidies, whether such subsidies are targeted or not. Two questions come to mind: (1) Why are business capital subsidies evidently good politics? and (2) Are business capital subsidies good economics? Fournier and Rasmussen do not deal adequately, if at all, with the former question. With respect to the latter, the aspect that interests me most is the effect of business capital subsidies on the allocation of investment.

In section II of the paper, Fournier and Rasmussen identify some of the rationales for providing business capital subsidies: redistribution of wealth or income, compensation for capital market imperfections, promotion of competition, and internalization of externalities. Let me comment briefly on these rationales. If the objective is redistributing wealth or income, the market mechanism is not a particularly efficient means of achieving the objective. We know this lesson by rote and from experience. With respect to market imperfections, we also know from experience that government is not particularly adept at perfecting anything. In some cases, however, government has been successful at scaling down its own contribution to market imperfections. Nevertheless, government intervention to deal with market failure does not necessarily mean governmental success. With respect to promoting competition, the U.S. economy is not likely to be moved measurably toward the competitive pole by indirect means such as business capital subsidies. Finally, externalities must not be confounded with public goods (bads). Internalizing

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics and Dean of the College of Business and Management Studies at the University of South Alabama.

externalities is one thing, but satisfying first-order optimality conditions for efficient provision of social benefits that appear simultaneously and irreducibly in two or more utility or production functions is another.

All of these foregoing rationales deal with *targeted* business capital subsidies. We know that, if government were a boy scout, it would not earn its archery merit badge. Let me turn aside these rationales, however, and focus instead on still another rationale that underlies a case made by certain proponents of business capital subsidies. This rationale concerns tax implications for capital allocation. Fournier and Rasmussen are silent on this rationale, even though it deals with the "allocation of investment in the economy as a whole," which they cite early as a prime interest of economists. This rationale is a kind of second-best argument recognizing that our tax laws are rigged in favor of owner-occupied housing! After all, homeowners pay no tax on imputed rent and receive preferential capital gains treatment.

Net (of depreciation) user costs of capital have been estimated for several types of nonfinancial capital: producer durables and structures of both corporations and unincorporated businesses, rental housing, and owner-occupied housing. Because of differences in taxation and financing, net user costs of capital are lower for housing, particularly owner-occupied housing, than for nonresidential capital. Hendershott and Shilling (1982) estimate the net (of depreciation) user costs of capital immediately before the Economic Recovery Tax Act (ERTA) of 1981 for corporate capital, rental housing, and owner-occupied housing. Ignoring risk considerations and possible externalities, net user costs should be equal across all types of capital if it is to be allocated efficiently in the economy. Prior to ERTA, the net user cost of capital was two percentage points above that of rental housing and five percentage points above the weighted average net cost of owner-occupied housing. After ERTA, the net user costs of corporate capital and rental housing are *equal* and that of owner-occupied housing is only three percentage points less. When the net user cost of owner-occupied housing is examined by income class, the net user cost is significantly (four to five percentage points) below that of both rental housing and corporate capital for upper-middle ($25–50 thousand) and high-income (more than $50 thousand) classes.

The underlying meaning of these estimates is that there is or has been overinvestment in owner-occupied housing and underinvestment in corporate or industrial capital. In other words, because of tax laws, we are or were overhoused and underindustrialized. Hendershott and Shilling (1982, p. 242) point out that the "obvious economic, although not political, solution to this misallocation problem would be to tax owner-occupied housing more heavily (for example, tax imputed rents), thereby raising its user cost relative to that of industrial capital." The same effect on relative net user costs could be achieved by taxing industrial capital less heavily. A way of putting this point is that, instead of removing subsidies to owner-occupied housing, subsidies would be extended to business capital. ERTA was a step in this direction.

A property of unfettered, freely functioning capital markets is that, at the margin, all capital is equally productive. In effect, Hendershott and Shilling developed a case for subsidies to business capital based on closing the gap between net user costs. Notice should be taken, however, that they do not make a case for targeted business capital subsidies. Much is known of the loss from leaky buckets used to tote transfers from one group to another group targeted for subsidy. The bucket is particularly leaky when the market mechanism is used. In addition, much is known about the utilities of bureaucrats who act to maximize their own interests.

In a sense, the policy implications and other conclusions of the paper are disappointing. Perhaps the disappointment stems from a misleading title. From the title, one expects a careful analysis of the welfare implications of targeted business capital subsidies that is never forthcoming. What one gets is a limited enumeration of rationales and a truncated evaluation of ramifications. Yet, their paper succeeds in bringing attention to the likelihood that programs of business capital subsidies will not hit the target given by any one of several rationales commonly cited in cases made for such programs. There is much value in taking notice of points raised and scored by Fournier and Rasmussen, but one wishes that they had investigated the basis and underlying question of whether there are conditions or circumstances under which business capital subsidies are good economics and, if so, whether there are conditions or circumstances under which targeted business capital subsidies are reasonable means of actualizing such good economics. In any event, the allocation of investment in the economy as a whole is central to a true analysis of economic welfare implications of business capital subsidies. Business capital subsidies, capital allocation, and economic welfare are linked, and analysis of these linked elements goes beyond rationales and ramifications.

References

Fournier, Gary, and Rasmussen, David. "Targeted Capital Subsidies and Economic Welfare." *Cato Journal* 6 (Spring/Summer 1986): 295–312.

Hendershott, Patric H., and Shilling, James D. "Capital Allocation and the Economic Recovery Tax Act of 1981." *Public Finance Quarterly* 10 (April 1982): 242–73.

CONSTRAINING THE TRANSFER SOCIETY: CONSTITUTIONAL AND MORAL DIMENSIONS

Terry L. Anderson and Peter J. Hill

Introduction

The recent emphasis in the economics literature on transaction costs and contracting has provided economists with a much clearer understanding of the social coordination process in a market setting. Perhaps the most important conclusion to be drawn from this literature is that focusing solely on adjustments along the price and quantity margins does not capture how robust human action is. Market exchanges are often complex agreements between individuals, and involve principals hiring agents to carry out specific functions. These arrangements result in gains from trade (rents), the distribution of which must be specified through the contracts. Otherwise the rents would be always up for grabs until rights to them were defined and enforced through the contractual process. Hence there are benefits associated with resources devoted to contract specification but obviously there also are costs. Given these costs, it is in the interest of entrepreneurs to conserve on transaction or contracting costs. Self-enforcing contracts (Klein and Leffler 1981), residual claimancy (Alchian and Demsetz 1972), postcontractual opportunism (Klein, Crawford, and Alchian 1978), and wealth held hostage (Williamson 1983) are all examples of the insights into the contractual process that have come out of this way of thinking.

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The authors are Professors of Economics at Montana State University and Senior Associates of The Political Economy Research Center in Bozeman, Montana. This paper has benefited from comments provided at a 1980 Liberty Fund conference on "The Evolution of the Right to Property," a 1985 seminar at the Center for the Study of Public Choice, and a session at the 1985 American Economic Association meetings. Special thanks go to Lee Alston and Douglass North for their valuable insights.

By adapting the transaction cost/contracting tools to the area of social contracting, we can develop similar insights into the nature of government. Just as there are agents and principals who contract with one another in the marketplace, the political process has citizens (principals) who grant the power of coercion to an agency (government) in return for the provision of public sector goods and services. Out of this framework comes a positive theory of government based on transaction costs and contracting. This principal-agent framework suggests that constitutional and moral (ideological) limits are necessary for constraining political agents if excessive transfers are to be avoided. When applied to the U.S. experience, it appears that these limits were eroded during the 19th century, paving the way for the modern redistributive state.

A Principal–Agent Perspective

The principal-agent framework that has proved so useful for the study of the neoclassical firm can be fitted nicely to government once we accept the contractarian view. This contractarian view, developed by early philosophers and carried on today by such scholars as James Buchanan and Geoffrey Brennan (see Buchanan 1975; Brennan and Buchanan 1985), suggests that government is like a firm with which citizens contract in order to obtain protection, justice, and public goods. In this context constitutional, statutory, and common laws form the basis of the contract between governmental agents and citizens.

The literature on the contractual nature of the firm emphasizes transaction costs. In particular, this literature recognizes that when contracts are entered into, there are costs of measuring inputs and outputs and of monitoring agents. By explicitly recognizing these costs, we have come to better understand different forms of factor payments, leasing arrangements, franchising, and brand names. In this framework the neoclassical firm headed by a residual claimant becomes a mechanism for reducing transaction costs.

This principal-agent perspective is only beginning to be applied to governmental organization (see, for example, Kalt and Zupan 1984, Kau and Rubin 1979, and Peltzman 1984). The problem of insuring that the political agent acts on behalf of the citizen principal are fully as relevant as in the marketplace. Certainly transaction costs in the political sphere prevent perfect monitoring and measurement of agent performance and yield postcontractual opportunistic behavior. If the principal-agent relationship is not well specified and monitored in the political process, a transfer society can result. Large-scale rent seeking comes from incomplete and inadequately enforced social contracts. Competition among agents and legal rules will constrain the amount of transfer activity that takes place, but the question is whether these constraints are sufficient. Given the limits to political competition and the costs of monitoring and enforcing social contracts, it is our contention that ideological or moral dimensions of political agent behavior complement constitutions in constraining the transfer society.

To understand the complementary relation between constitutional and ideological dimensions of constraining the transfer society, we present seven postulates that form the basis for a principal-agent theory of government. These postulates begin by asking how we are able to emerge from the Hobbesian jungle and proceed to the question of how can we control Leviathan in a world of positive transaction costs.

Postulate 1. In the Hobbesian state of anarchy, "life is nasty, brutish and short" because there are no clear rights, and hence there is no basis for exchange. Wealth in such a state is always up for grabs in that individuals can gain it by devoting resources to predation. In such a world human interaction will result in negative-sum games that deplete resources as people battle over wealth. Such conditions foster transfer activity or rent-seeking behavior.

Postulate 2. In the Hobbesian state of anarchy there is an incentive for members of the society to agree on constitutional-level rules for constraining rent-seeking behavior. To move out of this state individuals must agree to an initial set of rights and to restrictions on their ability to take mutually agreed upon rights from others. Agreement, however, is not sufficient to guarantee that such takings will not occur, for as North (1981, p. 45) has pointed out, "the neoclassical model has an asymmetrical dilemma built into its behavioral function":

> It is certainly in the interests of a neoclassical actor to agree to constrain behavior by setting up a group of rules to govern individual action: hence the view that the Hobbesian state is a logical extension of the neoclassical model applied to a theory of the state. But it is also in the interests of the neoclassical actor to disobey those rules whenever an individualistic calculus of benefits and costs dictates such action.

To help overcome this dilemma, individuals consent to be coerced under certain conditions by the agency we commonly refer to as the state. The problem is specifying the agreement under which coercion is allowed to ensure a protective and productive role for the state.

Postulate 3. If transaction costs—that is, the costs of specifying and enforcing the contract—were zero, contracts to govern behavior and protect rights would be instantaneous. The Hobbesian state of anarchy would never exist under this condition and only voluntary, positive-sum games would result because no wealth would be up for grabs. The value of all goods would be captured by their owners and all costs would be internalized. No social contract would be necessary because there would be no protective or productive roles for the state.

Postulate 4. Unfortunately, transaction costs are positive, making the dilemma North refers to a very real problem. As with any contractual arrangement between principals and agents, it is necessary to specify the contract in a way that will allow measurement and monitoring. In the case of a constitutional contract, agents are hired by principals to enforce the initially agreed upon rights, thus establishing the protective role for the state. In addition, agents may be called on to produce certain goods for which exclusion is costly within a private contractual setting.

At this point we emphasize that there are two levels of contracting in the political arena. The first, which we concentrate on here, is constitutional, wherein the fundamental rules that govern how agents will carry out the day-to-day operation of the state are established. The second level of contracting, which is the focus of most political economy, takes place between agent-politicians and principal-constituencies to provide the normal functions of the state. The higher rule of law, or the constitutional contract, is between faceless individuals who agree to constrain their behavior vis-à-vis other faceless individuals, and therefore comes closer to a contract formed behind the Rawlsian veil of ignorance. In contrast, everyday politics, or statutory contracting, is the result of special interest groups contracting for governmental protection, production, and redistribution. Our concern here is with how the constitutional level of contracting constrains the behavior of principals and agents in the process of statutory contracting.

Depending on the costs of measuring and monitoring the performance of political agents, it is possible for agents to engage in postcontractual opportunism, which involves attempts by parties to the contract to capture existing rents that, under the terms of the constitutional contract, were to accrue to other parties (Klein et al. 1978). Whenever property rights to rents (gains from trade) that result from contracting are not well defined and enforced, opportunism by one party is likely. If it is difficult to measure performance and monitor behavior, one party to the contract may be able to capture a portion of the rent that was supposedly the property of other parties.

Opportunities for postcontractual opportunism exist on many more margins as the transaction costs rise.

Postcontractual opportunism as used here refers to the actions of agents that violate the constitutional contract. When we suggest that such principal-agent actions lead to postcontractual opportunism, we mean that the constitutional contract is not sufficiently specified or monitored to constrain agent behavior. A violation at the constitutional level can result in principal-agent contracts at the statutory level, and these principal-agent relationships may adequately constrain opportunistic behavior. In other words, principals or special interest groups capture agents and thus obtain transfers. Such capture is possible because performance under the constitutional contract is inadequately measured and monitored.

The main question addressed by the literature on the contractual nature of the firm is what are the mechanisms used to reduce these transaction costs and thereby reduce the extent of postcontractual opportunism. This issue is illustrated particularly well when one party to a contract brings a specialized asset that has few alternative uses to the agreement. In this situation, the other party may agree to behave in a certain way by providing other inputs that, when combined with the specialized asset, generate greater output than the contracting parties could produce separately. Once the owner of the specialized asset agrees to the contract, he may find the other party threatening to withhold inputs with the intention of capturing more of the total rents. The fewer the alternative employment opportunities for the asset, the more it will be subject to postcontractual opportunism. It is in this context that Klein et al. (1978) find the explanation for vertical integration, which internalizes the rents associated with the specialized asset.

The point to emphasize in the case of firms with residual claimants engaging in private contracting is that there is an incentive to reduce the extent of postcontractual opportunistic behavior. Three aspects of private contracting make this the case.

First, there are clear residual claimants who receive the gains and suffer the losses when the contractual process works or does not work. Agents and principals alike must monitor the terms of the contract to insure that they capture the residual or gains from trade due them.

Second, since market transactions generate prices, these prices provide inexpensive information about the performance of agents. For example, even in a large corporation where there is a long chain of principal-agent relationships, the residual claimant *qua* stockholder can observe the asset price as a measure of contractual performance. Even when the stockholder may remain rationally ignorant, individuals such as T. Boone Pickens have an incentive to attempt a takeover of the company, replace the "good old boy" agents (those engaging in postcontractual opportunism) with new agents, and make a profit. At least part of the information for such takeovers comes in the form of asset prices.

Third, postcontractual opportunism is constrained by competition. Potential residual claimants who perceive that agents are acting opportunistically can offer a better deal to principals. In this way, brand names, repeat business, and company goodwill become assets of the agent and constrain opportunistic behavior. Should a principal find that the product or service he expected from a particular firm differs from what is actually received, the principal can choose another agent. The greater the degree to which there is competition among potential agents, the less likely it is that any one agent can engage in postcontractual opportunism. The Klein et al. argument that owners of specialized assets with few alternatives are likely to experience postcontractual opportunism and therefore opt for vertical integration hinges on the lack of competition. Probably no force constrains agents more than competition from other agents.

Postulate 5. Because the three elements that constrain agent behavior in a private contractual setting are lacking when we consider constitutional contracting, postcontractual opportunism by political agents is more likely. Whereas private contracts have clearly established residual claimants, constitutional contracts with political agents have no such counterpart. For the principals, the residual claim on actions that benefit society as a whole are very small, since they are shared with a large number of others, thus giving these principals ample incentive to remain rationally ignorant. Political agents are usually restricted from making profits from their roles. In fact, in our society bribes are not an acceptable form of political payment, and extensive efforts are put into discovering political actions that lead to personal gain.

Furthermore, in the context of constitutional contracting, measurement of performance is difficult. There certainly are no "asset prices" quoted on the New York Stock Exchange that tell how well the government is being run, and the absence of profits means there is no clear yardstick against which to measure contract performance. In general the characteristics of products and services produced by the public sector are difficult to measure. For example, it is nearly impossible to measure the optimal amount of such public goods as national defense or environmental quality. Therefore we cannot be sure whether political agents are doing the job for which they were hired.

Finally, the very definition of government as an agency with a monopoly on legitimate coercion suggests that competition among political agents will be lessened. Recall that under a contractarian theory of the state, the citizen agrees to allow coercion by an agent in return for the guarantee that he will be spared the nasty, brutish, and short life inherent in Hobbesian anarchy. Wealth is then created through the definition and enforcement of property rights, but this wealth is "specialized" if it cannot be moved easily to another political jurisdiction; in other words, the wealth created through the constitutional contract is a potentially appropriable rent to the extent that there are not competing political jurisdictions. "Voting with your feet" (Tiebout 1956) is always an option if the coercive powers of government are used to appropriate these rents, but the costs of doing so are often quite high. To the extent that they are high, there will be less competition among agencies and more opportunities for agents to appropriate rents for themselves or for other principals. Therefore, we can predict less transfer activity to take place at the local level, where it is relatively easy to move to another town, and more to take place at the national level. The problem of postcontractual opportunism to capture rents from citizens is even greater at the national level if the government has the power to restrict emigration, as is the case with the Soviet Union.

The major check on opportunistic behavior by political agents is that if they successfully capture too many rents created by the constitutional contract, there will be competition by other political coalitions (see North 1979). Interest group theories of regulation argue that this type of competition allows the capture of regulatory agents. Of course, if the benefits from regulation were simply a redistribution of wealth from another small, well-identified group, the competition among agents would be keen, and there would be less likelihood that the transfer would take place. However, the ability of agents to diffuse the costs through general taxation or deficit spending while concentrating the benefits makes it more difficult for competing agents trying to reduce transfer activity to develop a constituency.

To recapitulate, the fundamental problem for government is to develop a contract between principals and agents that allows agents to protect private property rights and to produce certain public goods for which exclusion is cheaper because of coercive power, but which does not allow agents to use their coercive power to engage in transfer activity. In fact, however, political agents recognize that they can gain support if they provide transfers to specific interest groups. Unfortunately, the protective and productive outputs specified at the constitutional level are like common pool resources or public goods where the benefits are diffused. Transfers, on the other hand, can be privatized by providing concentrated benefits. Agents seeking political support certainly recognize the difference between the two and act accordingly. Under these circumstances postcontractual opportunism in the form of transfer activity is likely to create Leviathan.

Postulate 6. One way of preventing political agents from acting opportunistically is to constrain them on as many margins as possible by carefully specifying the terms of the constitutional contract. At a minimum the contract must specify:

- The division of rents created by the initial contractual process. This would take the form of an agreed upon structure of property rights. These property rights, in essence, determine who has an ownership claim on wealth created as a result of the constitutional contract.
- The circumstances under which agents can exercise coercive power. The purpose and form of coercive power would be set out and limits on its use specified. For example, taxing power, due process, and decision rules must be delineated in the constitution.
- The methods of monitoring and enforcing contract performance by agents. A system of checks and balances among executive, legislative, and judicial branches would insure some monitoring by other agents. By specifying the role of different levels of government, it is possible to promote some competition at the state and local levels. For example, disallowing state interference with interstate commerce encourages states to compete for trade. Elections would also require a periodic review of performance and promote competition among agents. And to promote enforcement, a court system with an ultimate arbitrator and rules for removal of agents from office would be necessary.

Postulate 7. Of course, it would be naive to assume that margins for behavior could be sufficiently well specified to prevent all postcontractual opportunism. Even with private contracts that cover a narrow range of activities, the cost of specifying every margin will simply be too great. The constitutional contract—which covers a wide range of principal-agent relationships and has a monopoly on coercive power that necessarily limits competition from other agencies—is even less likely to prevent postcontractual opportunism.

At this point we must ask whether contractual performance by agents depends solely on narrow benefit-cost calculations regarding opportunistic behavior. As North (1981, pp. 46–47) states:

> [W]e also observe them obeying the rules when an individualistic calculus would have them do otherwise. Why do people not litter the countryside? Why don't they cheat or steal when the likelihood of punishment is negligible compared to the benefits? . . . The question for social scientists becomes, how much additional cost will I bear before I become a free rider and throw the beer cans out the car window?

In all social interaction some rights are honored and rules obeyed simply because people have a sense of right and wrong. This sense is the ideology or morality that determines "the premium individuals are willing to incur not to free ride" (North 1984, p. 39).

Ideology defined in this way serves a useful purpose in reducing the costs of specifying and enforcing the distribution of wealth agreed to in a contract. For instance, a basic commitment to honesty or keeping one's word will substantially reduce transaction costs. In the absence of such an ideology, the gains from trade possible through market transactions would be substantially reduced.

Ideology will be even more important to contractual performance in cases where measurement is more costly and competition from other agents limited. If the sense of right and wrong for political agents is consistent with the intention of the social contract, there will be less postcontractual opportunism. For the constitutional contract to work, there must be some feeling among the parties that the distribution of wealth is just and some willingness to sacrifice increases in personal wealth to adhere to this distribution. However, if there is little agreement that the social contract is just, efforts will be devoted to using the governmental coercive power to redistribute wealth. Given that political agents are the ultimate enforcers of the constitutional contract through coercive power and there is no residual claimant, ideology becomes an important bonding agent for the social fabric.[1]

Gerald Sirkin (1976, p. 201) calls this bonding agent "Resource X," which represents "the self-disciplinary elements of Victorian compromise, the republican virtues and discipline of expectations that made individualism workable." Sirkin (p. 200) recognizes that

> the discipline of authority must, in an individualistic society, be replaced by self-discipline. This need cannot be evaded by

---

[1] The view of ideology presented here is different from that of Kalt and Zupan (1984), who use the term to describe "on-the-job consumption" by agents. We have no disagreement with their description of this behavior as one result of postcontractual opportunism in the principal-agent relationship. Their emphasis, however, is on statutory levels of contracting, while ours is on the importance of ideology at the constitutional level.

> individualistic choice of governmental authority, for, as long as the authority is individualistically chosen and is responsive to individuals, it will be no more disciplined than the individuals who chose it. Politics would then merely become the arena in which the chaotic bickering and mayhem occur.

If postcontractual opportunistic behavior by political agents is to be constrained, constitutional limits must complement and be complemented by an ideology consistent with the social contract. In the United States the social contract and ideology have been partially successful constraints on postcontractual opportunism.

The U.S. Experience

The Constitutional Contract

In the spring of 1787 a group of Americans gathered in Philadelphia to consider alterations to the Articles of Confederation. Adopted in 1781, the Articles had served as the contractual basis of the national government that followed the Declaration of Independence from England. Although the Articles had served well to coordinate certain governmental functions, they were seen by many as inadequate to the task because they did not provide for national taxation or the regulation of commerce. This constitutional contract also did not provide a national enforcement mechanism; it simply relied on the states to interpret and secure compliance with the provisions of the Articles. Thus, although a clear attempt was made to draw up a contract that would adequately empower agents to act on behalf of principals and also to limit their discretion, one can argue that the principal-agent relationship did not provide agents with sufficient authority to carry out their tasks.

The representatives from the states who met in 1787 were therefore committed to altering the existing contract or forging a new one. From the document framed by these men and the debate surrounding its writing and approval, it is evident that they had a clear understanding of the principal-agent problem and wanted to construct a contract that granted the agents enough power to accomplish their assigned tasks but also limited the agents' ability to engage in postcontractual opportunism. Their experience under the Articles of Confederation plus their relationship with the British Crown and Parliament before the Revolution provided ample reason to attempt to better specify the constitutional contract.

The concern for the adequacy of the contract between the principals and the agents was expressed in *Federalist*, no. 51, where James Madison wrote:

> In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself. . . .
>
> Ambition must be made to counteract ambition. The interest of the man must be connected with the constitutional rights of the place. It may be a reflection on human nature that such devices should be necessary to control the abuses of government. But what is government itself but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary.

In fact, the Federalist Papers can be viewed as a discussion of the necessity of an appropriately specified contract between principals and agents in the context of government. Much attention is given to justifying the Constitution as a document that appropriately constrains the agents and prevents postcontractual opportunism. There is a discussion of the role of the courts as a monitor of contract performance; of different spheres of influence for different parts of government as a way of maintaining competition; of the problem of a "tyranny of the majority"; and of the difference between constitutional or fundamental law (the basic contract) and legislative law. In *Federalist,* no. 78 Hamilton wrote:

> A constitution is, in fact, and must be regarded by the judges as, a fundamental law. It therefore belongs to them to ascertain its meaning as well as the meaning of any particular act proceeding from the legislative body. If there should happen to be an irreconcilable variance between the two, that which has the superior obligation and validity ought, of course, to be preferred; or, in other words, the Constitution ought to be preferred to the statute, the intention of the people to the intention of their *agents* [emphasis added].

The Constitution embodied several different decision rules, depending on the nature and importance of the decision, providing yet another indication that constraints upon agent behavior were deemed necessary. Decision rules varied from one-fifth majority necessary to record a vote, to unanimity necessary before a state could be deprived of its vote in the Senate. Between these were rules of simple majority for most legislative decisions and two-thirds and three-fourths majorities for different parts of the amendment process.

In addition to constraining agents through a formal, written document limiting the power of government, the Constitution encouraged competition among agents. It specified the frequency of elections, and in so doing provided a compromise between stability in government and competition among agents so they could not completely ignore the intention of the people. Competition was further enhanced by the last item in the Bill of Rights, which provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." This attempt to limit the domain of the federal government reflects the higher cost of exit at the national level and the benefits of competition among the state governments. Residual claimancy is also stronger on the part of the principals at the state and local levels, another consideration that was not lost on the Founding Fathers.

Three provisions of the Constitution were especially important for limiting postcontractual opportunism in the form of transfer activity. These were: (1) Article I, Section 10, the contract clause, which provides that "no state shall . . . pass any Bill of Attainder, ex post facto law or law impairing the Obligation of Contracts"; (2) Article I, Section 8, the commerce clause, which grants Congress the power "to regulate Commerce with foreign nations and among the several States and with the Indian Tribes"; and (3) Fifth Amendment (and later the Fourteenth), which provides that no person shall "be deprived of life, liberty, or property without due process of law."

All three clauses granted substantial security to private property rights and promoted positive-sum interaction through the market process. Freedom of contract and restrictions on the ability of states to interfere with commerce were necessary for social coordination through the exchange of well-enforced property rights.

The Supreme Court, particularly under Chief Justice John Marshall (1801–35), interpreted the Constitution in a manner that further solidified the document as an effective principal-agent contract. Marshall moved quickly to establish the Court's authority to review legislation and to negate legislation that was in conflict with the original contract. *Fletcher* v. *Peck* (1810) and *Dartmouth College* v. *Woodward* (1819) strengthened the contract clause and limited the ability of the federal government to hand out favors through contract modification. The Court also used the commerce clause to limit significantly the ability of states to use their coercive power to transfer resources, and the due process clause was an ever-present barrier to unlimited takings by government.

Over time, however, the interpretation of the contract changed in ways that made monitoring and enforcement more difficult. Early in the 19th century the contract clause lost some of its restrictive power when the Court decided that laws impairing the obligation of contracts were constitutional so long as they did not apply retroactively. But the most important alterations began with the decision in *Munn* v. *Illinois* (1877), which concerned the power of the Illinois state legislature to set grain storage rates for elevators. Although precedent led many to predict the Illinois law would be declared unconstitutional, the Court ruled (94 U.S. 126 [1877]):

> Property does become clothed with the public interest, when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created.

This became known as the public interest doctrine and was amorphous enough to leave a great deal of slack in the principal-agent relationship. With "public interest" unspecified, measuring and monitoring agent performance became more difficult. The problem was not so much that the power of government to regulate was expanded, but rather that such expansion was carried out in a way that agents could now find constitutional justification for numerous transfers of rights.

Further obfuscation of the contract occurred when the due process amendments were, over the next several decades, interpreted to mean that regulation of economic processes by states could occur, but that it must be reasonable. At times the doctrine of reasonable regulation was used to negate legislative interference with property rights, but at other times the Court deemed widespread intervention in the marketplace "reasonable." There was no specific constitutional provision by which courts could judge the reasonableness of any law; therefore it was clearly in the interests of affected parties to devote considerable resources to influencing both the legislative and judicial process.

The expansion of the regulatory power of government led to the creation of the Interstate Commerce Commission in 1887, and numerous other regulatory bodies soon followed. Again, the members of these bodies were serving as agents for the citizens of the United States, but there was no clear specification of the responsibilities of the members of these commissions or any provision for monitoring their performance.

Changes in the interpretation of the contract continued throughout the 19th and 20th centuries. Between 1875 and 1920 the police power of the state was increasingly used to justify interference with contracts. In several cases, particularly in *McCray* v. *United States* (1904), the courts granted the power to Congress to use its ability to tax to engage in explicit regulation. Also, in a series of cases between 1892 and 1911 the Court substantially expanded the power of the legislative branch to grant discretionary power to the executive. Congress needed only to outline the basic policy objectives; then a regulatory board or commission could write the necessary rules to implement the mechanics of the law, and these administrative rulings were declared to have the force of law. Again, both of these trends made monitoring of performance difficult, particularly because there was no clearly specified obligation of the agent in his relationship with principals.

The Great Depression did not represent a significant watershed in constitutional doctrine, but there were several cases that led to a further lack of specificity in the contract. *Nebbia* v. *New York* (1934) upheld a New York law that allowed a state milk control board to set maximum and minimum prices. In this case the Court expanded the public interest doctrine first set forth in *Munn* v. *Illinois* and removed once and for all any doubt as to when economic activity was "affected with the public interest." The Court held that all activity was so defined and that a state could adopt "whatever economic policy may reasonably be deemed to promote public welfare." A second case, *N.L.R.B.* v. *Jones and Laughlin Steel Corporation* (1937), expanded the stream of commerce doctrine to include all production, and thus justified governmental interference with all economic activity on the basis of the presumption that the materials for the production process likely were drawn from interstate commerce and likely went back into interstate commerce.

Two more recent cases have significantly altered the intent of the original contract. In *Berman* v. *Parker* (1954) the Supreme Court neutralized much of the power of the Fifth and Fourteenth Amendments when it decided that the "public use" portion of those amendments did not substantially limit the power of government to engage in large-scale takings of property. Even more significant, in *Hawaii Housing Authority* v. *Midkiff* (1984), the Court allowed the Hawaii Land Reform Act of 1967 to stand. Under this act, the state's housing authority took property from large land owners and resold it to others. The justification for the legislation was the small amount and high price of residential land for sale on the islands. The act allowed the state housing authority to invoke eminent domain on behalf of those leasing land to then resell the land to the lessees. Thus, under the Court's recent interpretation, eminent domain is viewed as broadly as police power, leaving nothing that limits legislatures from engaging in wholesale takings.

The U.S. Constitution was designed to clearly specify the principal-agent relationship in government, to limit the ability of the agents to engage in postcontractual opportunism, and to provide a reasonably adequate basis for monitoring the performance of the agents. However, over the last two centuries, court interpretations have moved us to a much more ambiguous and less clearly specified contract. The opportunity for agents to shirk is much greater than previously, since there are many more margins at which postcontractual opportunism can occur. In the absence of a well-specified and enforced contract, more reliance must be placed on ideological constraints on agents.

Ideological Constraints on Transfers

Just as the constitutional contract constrained political agents, attitudes toward property during the first century of our nation's history reduced enforcement costs. Over time, however, these attitudes and enforcement costs have changed. The evidence suggests that ideology was a useful complement to the U.S. Constitution during the earlier period.

One of the distinguishing features of colonial America was the general acceptance of the Lockean concept of natural rights. This concept provided the colonists with a generally understood common point for determining the origin and sanctity of rights.[2] Although classical writers, including Plato and Aristotle, had a type of natural rights philosophy in their works, their position tended to emphasize the duties of man rather than the rights of man (Strauss 1953, p. 182). It was not until John Locke published his *Second Treatise on Civil Government* in 1690 that a more complete theory of the rights of the individual to property was put forth. Locke argued that the right to self-preservation gave the individual the right to any property with which he mixed his labor. This right of appropriation, however, was not limited to only that for which he had an immediate use. Since money allows for store of value and trade provides a mechanism whereby property of less value can be bartered for property of greater value, Locke believed natural rights were unlimited. Under Locke's theory, property rights were not created by government or by law, but were a part of the natural order of the universe. Therefore anyone who knowingly violated another's property was morally guilty of violating one of the basic universal principles of life.

The general acceptance of the concept of natural rights was found in everything from colonial education to religion to politics. Speaking of property in 1768, Samuel Adams (1949, p. 66) said "it is an essential, unalterable right, in nature, ungrafted into the British Constitution, as a fundamental law, and ever held sacred and irrevocable by the Subjects within the Realm, that what a man has honestly acquired is absolutely his own, which he may freely give, but cannot be taken from him without his consent."[3]

---

[2] See Hofstadter (1977) for a good discussion of colonial attitudes regarding natural rights.

In higher education the influence of natural rights was reflected in the teaching of John Witherspoon, president of Princeton University from 1768 until his death in 1794. In both their junior and senior years, students attended Witherspoon's lectures on moral philosophy. In attendance at those lectures were numerous future leaders, including 1 president, 4 members of the Second Continental Congress, 15 senators, 24 congressmen, 3 Supreme Court justices, and 12 state governors (Persons 1958, p. 136). Persons (1958, pp. 136–37) summarizes Witherspoon's lectures on moral philosophy:

> Moral philosophy as taught by Witherspoon consisted of three branches: ethics, jurisprudence, and politics. Each dealt with different aspects of moral obligation in human relationships and was properly studied in conjunction with the others. . . . Witherspoon devoted considerable attention to the rights and obligations of property. Prevailing practices with respect to private property were, he believed, a good index of the moral character of any society.

Further evidence of the respect for property rights can be found in recorded thoughts and teachings of colonial ministers.[4] The clergy, particularly in New England, were well-educated, commanded great respect, and were seen as a source of authority (Baldwin 1965).[5] They were responsible for educating and persuading the populace on theology as well as political theory and natural science. In addition to regular Sunday sermons, ministers gave lectures on a weekly basis and addresses on special occasions such as election day. In view of their considerable influence, it is significant that the clergy felt strongly and spoke so fervently on liberty and rights. As Baldwin (1965, p. xii) points out:

> The New England clergy preserved, extended, and popularized the essential doctrines of political philosophy, thus making familiar to every churchgoing New Englander long before 1763 not only the doctrines of natural right, the social contract, and the right of resistance but also the fundamental principle of American constitutional law.

---

[3] See Corwin (1955) and Strauss (1953) for a more complete discussion of the development of the doctrine of natural rights.

[4] See, for instance, Cole (n.d.) and Baldwin (1965).

[5] Forty-eight of 52 ministers in New Hampshire in 1764 were college graduates (Baldwin 1965, p. 3).

Political leaders also accepted the doctrine of natural rights and built institutions around it. Both the Declaration of Independence and the Constitution strongly reflect the Lockean concept of the compact theory of the state, namely, that government derives all of its powers from the consent of the governed and is created to protect natural rights including the right to property. The Founding Fathers saw as their primary task the construction of a system of government that possessed enough power to carry out the minimal functions of the state, yet not so much as to violate fundamental rights or allow agents to engage in postcontractual opportunism. In fact, so strong was their belief in fundamental rights that many opposed the Bill of Rights on the grounds that such fundamental rights did not have to be enumerated.

Thus, the principal-agent problem was partly solved by the adherence to a natural rights doctrine, which provided an additional means of contract enforcement. Because both the principals and the agents shared a philosophy that defined a set of rules (property rights) governing the division of rents, more explicit specification of the contract was not necessary. The use of ideology to aid in enforcement of the social contract continued through much of the 19th century. As late as 1868 the Supreme Court invalidated a statute on the grounds that it violated vested rights without reference to any explicit provision of the Constitution. Nineteenth-century moral philosophy continued to reflect a natural rights view. For instance, Francis Wayland's popular *Elements of Political Economy*, published in 1837, continually emphasized the sanctity of property rights (Persons 1958, p. 196).

However, even in the 19th century, doctrines were beginning to take hold that would eventually lead to the downfall of natural rights theory. An attempt was made to replace nature with history, or to find the rights of man in the historical process. "The end result of that attempt was absolute and unqualified failure. The attempt to replace natural right with historical right ended not in historical political philosophy, but in nihilism" (Jaffa 1978, p. 9). Likewise, the growth of utilitarianism led to less adherence to natural rights, as the idea of "greatest good for the greatest number" justified redistribution without consent of property owners.

The universal validity of the natural rights doctrine was also being challenged. While the 18th-century mind considered man's basic nature and moral standard to be invariant in time and space, historian Richard Hofstadter (1959, pp. 16–17) states:

> But no man who is as well abreast of modern science as the Fathers were of eighteenth-century science believes any longer in unchanging human nature. Modern humanistic thinkers who seek for a

> means by which society may transcend eternal conflict and rigid adherence to property rights as its integrating principles can expect no answer in the philosophy of balanced government as it was set down by the Constitution-makers of 1787.

Further evidence of the change in attitude toward universal principles can be found in *Situation Ethics* (1966) by Joseph Fletcher. The premise of the book is that any action can be right, depending on the situation. Again, a defense of property rights can be derived from such an ethical standard, but there will be continual conflict over rights. Also, situation ethics and moral relativism have led to moral nihilism. The argument that all moral questions are pragmatic or relative questions has led many to the position that no moral judgments can be made about anything. To the extent that these moral judgments cannot be made, ideology as a constraint on postcontractual opportunism loses much of its power. The result of this amorality is captured by William J. Bennett (1976, p. 915):

> The dangers of the myth [of the ethical sufficiency of law] are evident. Its tendency to make society more litigious, its emphasis on a compulsory morality rather than a voluntary one, encourages a morality of threats, which is in fact no morality at all. Recourse to law and courts occurs most often because private settlement and ordering have failed.

This politicization of society means that many issues traditionally treated as private moral questions become sources of legal conflict. As Robert Nisbet (1975, p. 5) puts it, we are at a "twilight of authority":

> What we are also witnessing, and this tragically, is rising opposition to the central values of the political community as we have known them for the past two centuries: freedom, rights, due process, privacy, and welfare. . . . To lose, as I believe we are losing, this structure of values is surely among the more desolating facts in the present decline of the West.

To the extent that respect for property as an ethical standard is declining, clear specification and monitoring of the principal-agent relationship can only occur if additional resources are devoted to the process. In the absence of a strong moral belief in the sanctity of private property rights, a strongly enforced constitutional contract is the only deterrent of transfer activity. Though we have not found a way to quantify the impact of ideological change, it is clear ideological convictions were changing the principal-agent relationship. North (1981, p. 198) summarizes the impact of these changes:

> The clearest reflection of ideological transformation was the evolving attitude of the judiciary. The gradual transformation of the attitude of the Supreme Court was a long process. . . . The ideological

> transformation was still in process by 1914, but it would be established definitively in the 1930s.

With the Great Depression and the writings of John Maynard Keynes came the solidification of the transfer society. What Buchanan (1985) has called "Victorian fiscal morality" allowed political agents to use debt financing as a fiscal tool only during wars and serious business downturns. Certainly the Great Depression fit the latter category, but the use of deficit financing did not stop with the 1930s. Buchanan (1985, p. 1) writes that in this century debt financing has "ceased to be immoral," although perhaps "rationally chosen constraints can be introduced to serve, *in part*, as substitutes for the eroded moral rules" (emphasis added). But without complementary ideological constraints on fiscal responsibility, it is questionable how long the substitution of explicit rules for moral norms will work.

Conclusion

We have argued that the Founding Fathers' respect for property rights derived from their belief in natural rights, and this belief exerted a significant constraint on individual behavior. They believed that in order for self-government to succeed, a strong influence from the ethical code was also essential. In other words, as James Madison wrote, "To suppose that any form of government will secure liberty or happiness without any virtue in the people, is a chimerical idea."[6]

Nevertheless, the Founding Fathers did not feel that people automatically respected rights, particularly when the coercive power of government could be used to violate rights. Madison felt that "neither moral nor religious motive can be relied on as an adequate control" (*Federalist*, no. 10). Alexander Hamilton's position in *Federalist*, no. 6 was even stronger:

> To trust to man's inherent goodness would be to forget that men are ambitious, vindictive, and rapacious. . . . Has it not, on the contrary, invariably been found that momentary passions, and immediate interests, have a more active and imperious control over human conduct than general or remote considerations of policy, utility or justice?

To reinforce the ideological constraints on political agents, the Founding Fathers were willing to invest resources in contractual mechanisms that would serve to protect natural or vested rights.

---

[6] Quoted in Bennett (1976, p. 910). Also see Landi (1975) for a discussion of Madison's view of the good society. Landi argues that Madison saw virtue and its pursuit as important to the good society. Liberty was viewed as an important condition for such pursuit.

Given the respect for rights generated by the natural rights doctrine, however, enforcement could occur with a relatively small commitment of resources.

Buttressing the constraints created by belief in natural rights and the explicit constitutional rules was the decentralized nature of early American society. "If Americans early displayed a strong interest in laws and institutions limiting the exercise of political authority, they also pioneered in the development of self-sustaining local government" (Roche 1969, p. 229). Even in the absence of an ethical code, respect for property was observed in small communities, in part, due to the expected costs of violating the rights of others. The smaller the group, the lower the costs of monitoring political agents because information is more readily available. Changes in these monitoring costs have greatly influenced the effectiveness of constitutional constraints.

One of the most significant changes in the costs of violating any given ideological standard has come with increased urbanization. As Buchanan (1978, p. 365) states, "The force of moral-ethical principle in influencing behavior is directly dependent on the size of community within which action takes place." Monitoring costs increase significantly as a large portion of one's social interaction takes place with other individuals who will never be seen again. In 18th- and early 19th-century America, almost every individual acted in a social setting in which he or she was familiar to others. Even those who worked in a factory lived in close proximity to their workmates. In 1790 only 5 percent of the population resided in urban areas of 2,500 or more.

The increasing industrialization, growing national markets, increasing occupational and geographic mobility, rising agricultural productivity, and improving urban transportation made cities much more economically viable. By 1970, 73 percent of the U.S. population was living in urban areas containing 2,500 or more residents. Thus, antisocial behavior, or lack of respect for others rights, resulted in less social disapproval.

During the past century there have been few explicit changes in the social contract governing political agents, but there have been significant changes in the costs of monitoring and enforcing that contract. Economic historians studying the growth process have focused almost entirely on technological changes with accompanying economies of scale that have altered the degree of centralization in our society. What they have not considered is why and how ideology has changed.

Our focus has been on the complementary relationship of constitutional and ideological constraints on principal-agent relationships. Constitutions without the appropriate accompanying ideology are likely to fail. No document can adequately protect all the potential margins from postcontractual opportunism. Once the coercive power is in place the principal-agent problem is almost intractable without some general acceptance of appropriate behavior standards by both parties. Many South American countries have had constitutions similar to the U.S. Constitution, yet they generally have failed in their attempts at constraining both the principals and the agents.

Likewise, attempts to constrain postcontractual opportunism through ideology in the absence of a formal, written document are likely to be less than successful. The English common law system, for example, illustrates the difficulty of enforcing a social contract without a clear-cut specification of the terms of that contract. Although the English courts have used the concept of an original social contract to negate legislation contrary to that contract, the absence of a written document has made it difficult to monitor performance and to determine precisely when the contract has been violated.

We believe that the principal-agent approach to the study of government allows important insights into the nature and scope of government. This approach suggests that the lack of a clear residual claimant, the lack of competition due to the high costs of exiting from the contract, and the high costs of monitoring and measuring performance in the absence of prices have all contributed to the growth of our transfer society. Only a combination of explicit constitutional rules and an ideology consistent with those rules can constrain the transfer society. Therefore, the task for social scientists is to develop a theory that explains why the ideological constraints that existed at the birth of our nation have eroded.

References

Adams, Samuel. "Massachusetts Circular Letter." In *Documents of American History,* 5th ed. Edited by Henry Steele Commager. New York: Appleton-Century-Crofts, Inc., 1949.

Alchian, Armen A., and Demsetz, Harold. "Production, Information Costs, and Economic Organization." *American Economic Review* 62 (December 1972): 777–95.

Baldwin, Alice M. *The New England Clergy and the American Revolution.* New York: Frederick Ungar Publishing Co., 1965.

Bennett, William J. "The Constitution and the Moral Order." *Hastings Constitutional Law Quarterly* 3 (Fall 1976): 899–918.

Brennan, Geoffrey, and Buchanan, James M. *The Reason of Rules.* Cambridge: Cambridge University Press, 1985.

Buchanan, James M. *The Limits of Liberty*. Chicago: University of Chicago Press, 1975.

Buchanan, James M. "Market, States, and the Extent of Morals." *American Economic Review* 68 (May 1978): 364–68.

Buchanan, James M. "The Moral Dimensions of Debt Financing." *Economic Inquiry* 22 (January 1985): 1–6.

Cole, Franklin P., ed. *They Preached Liberty*. Indianapolis: Liberty Press, n.d.

Corwin, Edward S. *The "Higher Law" Background of American Constitutional Law*. Ithaca, N.Y.: Cornell University Press, 1955.

Diamond, Martin. "Ethics and Politics: The American Way." In *The Moral Foundations of the American Republic*. Edited by Robert H. Horwitz. Charlottesville: University Press of Virginia, 1977.

Fletcher, Joseph. *Situation Ethics*. Philadelphia: Westminster Press, 1966.

Hofstadter, Richard. *The American Political Tradition*. 1948. Reprint. New York: Alfred A. Knopf, 1959.

Hofstadter, Richard. "The Founding Fathers: An Age of Realism." In *The Moral Foundations of the American Republic*. Edited by Robert H. Horwitz. Charlottesville: University Press of Virginia, 1977.

Jaffa, Harry V. *How to Think About the American Revolution*. Durham, N.C.: Carolina Academic Press, 1978.

Kalt, Joseph P., and Zupan, Mark A. "Capture and Ideology in the Economic Theory of Politics." *American Economic Review* 74 (June 1984): 297–300.

Kau, James B., and Rubin, Paul H. "Self-Interest, Ideology and Logrolling in Congressional Voting." *Journal of Law and Economics* 22 (October 1979): 365–84.

Klein, Benjamin; Crawford, Robert G.; and Alchian, Armen A. "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process." *Journal of Law and Economics* 21 (October 1978): 297–326.

Klein, Benjamin, and Leffler, K. B. "The Role of Market Forces in Assuring Contractual Performance." *Journal of Political Economy* 89 (August 1981): 615–41.

Landi, Alexander. "Was the American Founding a Lockean Enterprise? The Case of James Madison." *The Intercollegiate Review* 10 (Spring 1975): 95–105.

Nisbet, Robert. *Twilight of Authority*. New York: Oxford University Press, 1975.

North, Douglass C. "A Framework for Analyzing the State in Economic History." *Explorations in Economic History* 16 (July 1979): 249–59.

North, Douglass C. *Structure and Change in Economic History*. New York: W. W. Norton, 1981.

North, Douglass C. "Three Approaches to the Study of Institutions." In *Neoclassical Political Economy: The Analysis of Rent-Seeking and DUP Activities*. Edited by David C. Colander. Cambridge, Mass.: Ballinger Publishing Co., 1984.

Peltzman, Sam. "Constituent Interest and Congressional Voting." *Journal of Law and Economics* 27 (April 1984): 181–210.

Persons, Stow. *American Minds*. New York: Henry Holt Co., 1958.

Phelps, Edmund S., ed. *Altruism, Morality, and Economic Theory.* New York: Russell Sage Foundation, 1975.

Roche, George Charles III. *Legacy of Freedom.* New Rochelle, N.Y.: Arlington House, 1969.

Sirkin, Gerald. "Resource X and the Theory of Retro-Development." In *Economics of Resources.* Edited by Robert L. Leiter and Stanley L. Friedlander. Vol. 3: Annual volume of the Department of Economics, City College of the City University of New York. New York: Cyrco Press, 1976.

Smith, Wilson. *Professors and Public Ethics: Studies of Northern Moral Philosophers Before the Civil War.* Ithaca: Cornell University Press, 1956.

Strauss, Leo. *Natural Right and History.* Chicago: University of Chicago Press, 1953.

Tiebout, Charles. "A Pure Theory of Local Expenditures." *Journal of Political Economy* 64 (October 1956): 416–24.

Williamson, Oliver E. "Credible Commitments Using Hostages to Support Exchange." *American Economic Review* 83 (September 1983): 519–40.

IDEOLOGY AS THE ULTIMATE ENFORCEMENT MECHANISM

Thomas S. McCaleb

Professors Anderson and Hill (1986) attempt to explain the growth of rent seeking in American society in the following way. Governments emerge to reduce unproductive rent-seeking activities. Once governments with coercive powers are created, however, constraints must be imposed on political agents to prevent or minimize rent seeking within and through government. Social contracts are one form of constraint on government, but the constraints of social contracts must be supplemented by ideology to be fully effective. American constitutional history is characterized by a deterioration in the constraints imposed by the social contract, necessitating increased reliance on ideology.

In this analysis Anderson and Hill adopt the "new" contract theory of the state—an application of the economic analysis of principal-agent relationships—as an explanation of the existence of government. Although I too have used this contractarian framework, it clearly has limitations. Anderson and Hill seem less aware of or less concerned with the limitations than I have been. I believe the contractarian approach is most appropriately viewed as a "what if" statement. What if the origins of the state lay in a social contract by which individuals organized themselves to establish property rights and thereby to promote more efficient utilization of resources? Then, what sorts of rules and institutions of government would logically be established to accomplish those ends?

Anderson and Hill, on the other hand, seem to have adopted the contractarian approach as a positive, descriptive theory of the origins of government. They seem to believe that governments really were

---

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Assistant Vice-President for Academic Affairs and Associate Professor of Economics at Florida State University.

consciously created by the citizenry as explicit solutions to the rent-seeking problem. But my limited reading of history makes me somewhat skeptical of the historical accuracy of the contract theory of the state. I believe one could make a strong case that fundamentally, in a historical sense, the state was a creature of power that emerged as the ultimate rent-seeking agency without any artifact such as a social contract, whether explicit or implicit. The social contract, if it exists, is of relatively recent origin.

At the same time, while I am skeptical of Anderson and Hill's interpretation of the contract theory of the state, I strongly concur with their emphasis on the role of ideology, or what I prefer to call the civic culture, a notion recently popularized by Douglass North (1981).[1] To see the importance of ideology, or the civic culture, as a glue that holds society together and makes social interaction possible, it is only necessary to think about a community that relies on contract alone to govern interpersonal relations. Each contract represents a transaction that provides mutual gains to all of the parties to the contract and therefore improves the total well-being of the individuals involved. In the absence of any enforcement mechanism, however, some parties to the contract could obtain a disproportionate share of the available gains by violating the contract. If all engage in such nonsocial behavior, the contract breaks down. To reduce nonsocial behavior, an ultimate enforcement mechanism—government—is created by social contract. The unresolved problem for the contractarian view of society, however, is who or what prevents nonsocial behavior among the enforcers. Ideology, or the civic culture, provides an answer.

In a recently published paper, Richard Wagner and I (McCaleb and Wagner 1986) looked at attempts to test empirically one form of nonsocial behavior, the phenomenon of free riding. First, there were several experimental studies that found at most only a moderate degree of free riding, and in some cases very little free riding at all. Then there appeared a second group of studies, quite critical of the first, that argued that the earlier studies were improperly constructed and were contaminated in ways that biased the outcome of the experiment against free riding. This second group of studies constructed experimental environments that were cleansed of these allegedly contaminating elements, and not surprisingly they were then able to show evidence of a greater degree of free riding.

---

[1] The term "civic culture" is borrowed from Almond and Verba (1963), although I use it in a different (but not unrelated) context.

But Wagner and I noticed something very interesting. No matter how pure an environment was created in this second group of studies, no matter how strongly the structure of the experiment favored free riding, no experimental study produced results consistent with complete or even strong free riding. Clearly, something other than the calculus of immediate measurable costs and benefits motivates human action, even in a purely experimental setting. We attribute this outcome in part to the strength of the civic culture that is imparted, beginning at birth, in every civilization. Societies create all sorts of other institutions, some of which have been extensively analyzed in the economic theory of contract, to alleviate the incentives toward nonsocial free riding behavior, but ultimately these devices must rest on the existence and observance of the civic culture.

Once one recognizes the importance of ideology or the civic culture for the efficient operation of societies, it is fair to ask why the social contract is needed at all. Indeed, one could argue that the social contract where it exists creates its own inefficiencies. As the social contract closes off some avenues of rent seeking, agents find other less efficient avenues. If agents are prevented from seeking cash subsidies from governments, they will arrange for less efficient noncash subsidies or they will attempt to transfer wealth to themselves through such cumbersome and inefficient regulatory devices as price controls, occupational licensing, and so on. It is arguable then whether society might not be better off with open, direct rent seeking not constrained by social contract. In fact, the most efficient, perhaps the only, mechanism for closing off the obvious and direct avenues for rent seeking without redirecting rent-seeking activity into less desirable and less efficient channels is the inculcation and promotion of a civic culture that militates against rent seeking.

Anderson and Hill argue to the contrary that attempts to restrain nonsocial behavior through ideology alone will be less successful in the absence of a formal written social contract or constitution. As evidence they cite the difficulty in England of "enforcing a social contract without a clear-cut specification of the terms of that contract." But do we have any firmer notion of the terms of our social contract than do the English? Indeed, we have recently been told by one of our Supreme Court justices that the terms of our social contract will be adjusted to fit whatever notions of right might prevail among him and his brethren at any time. This hardly seems to be the stuff of which clear-cut specifications are made.

Fundamentally, I am unsure that Anderson and Hill's distinction between social contract and ideology is really meaningful. Ideology is the ultimate enforcement mechanism without which any form of contract, social or otherwise, would be of little use. The historical breakdown of constraints on rent-seeking behavior did not occur because the social contract had been weakened, necessitating greater reliance on ideology. Rather, the civic culture itself has changed, and the interpretation of the social contract has followed that change in the civic culture. Placing greater reliance on this changing ideology is not then a solution to the problems perceived by Anderson and Hill. Only by remolding the ideology or civic culture can a more preferred state of affairs be obtained. For this reason, reliance on constitutional alterations such as the proposed balanced budget amendment to constrain rent-seeking behavior by political agents is doomed to failure without an accompanying change in the civic culture. In the absence of change in the civic culture, such amendments may well raise the costs imposed on society by rent-seeking activity if they redirect that activity into less efficient channels.

The reliance that Anderson and Hill place on the potentially constraining influence of the social contract arises from a common methodological fallacy. Anderson and Hill frequently emphasize the successes of private contracts in channeling economic and social activity into mutually beneficial directions, but I fear that sometimes they are all too sanguine about imperfections in private contractual relations. Public choice economists have long criticized social welfare economists for emphasizing market failures while assuming perfect performance by government. There has been of late, however, a rather pronounced tendency on their part to emphasize government failure while assuming the near-perfect performance of private markets. Although not egregious, I believe that this fallacy is suggested by Anderson and Hill's discussion.

For example, Anderson and Hill place great reliance on business mergers and acquisitions as the ultimate protection of shareholders against nonsocial rent seeking by business managers. In fact, managers have available to them a number of devices to make such acquisitions costly, thereby providing some protection for rent seeking within the firm. Not the least of these is managerial control over important information about the firm. Accounting data are, after all, based on convention and are subject to manipulation, thereby making the monitoring of managerial behavior costly for shareholders and potential management rivals alike.

Neither the perfect government nor the perfect market viewpoint is valid. Nonsocial behavior in the form of free riding, rent seeking, and so on poses potential problems for all social interaction. Communities successfully utilize a variety of methods for ameliorating the perverse effects of such behavior. Some institutional arrangements exist in private markets, including but not limited to various forms of contractual arrangements. Other institutional arrangements exist within or are provided through government, including the establishment and enforcement of property rights without which private contractual arrangements would be of little value. All of these institutional arrangements leave substantial room for nonsocial behavior, so that the ultimate constraining influence must be noninstitutional, that is, ideology or the civic culture.

References

Almond, Gabriel A., and Verba, Sidney. *The Civic Culture: Political Attitudes and Democracy in Five Nations*. Princeton, N.J.: Princeton University Press, 1963.

Anderson, Terry L., and Hill, Peter J. "Constraining the Transfer Society: Constitutional and Moral Dimensions." *Cato Journal* 6 (Spring/Summer 1986): 317–39.

McCaleb, Thomas S., and Wagner, Richard E. "The Experimental Search for Free Riders: Some Reflections and Observations." *Public Choice* 47 (1985): 479–90.

North, Douglass C. *Structure and Change in Economic History*. New York: W. W. Norton, 1981.

A CONSTITUTIONAL APPROACH TO TAXES AND TRANSFERS

William A. Niskanen

Introduction

What are the characteristics of a "fair" system of taxes and transfers? All too often, contemporary political discussion of taxes and transfers uses a concept of fairness that provides little basis for agreement. A proposed change in taxes or transfers is usually considered fair only when it benefits one's own group or some other group that one favors, whether or not the existing taxes and transfers are fair by any standard. In this context, agreement is possible only if those who would pay higher taxes have some *marginal* benevolence toward those who would receive higher transfers (or lower taxes), given the existing distribution of income after taxes and transfers. Given the existing welfare state, this set of "Pareto optimal redistributions," a concept first developed by Harold Hochman and James Rogers (1969), may be empty. In this context, without such marginal benevolence, any system of taxes and transfers is a negative-sum game, a form of legalized theft, reducing the total income of the community. The conventional focus on the distributional outcomes of this game, thus, is not a sufficient basis for determining whether these outcomes are the results of a fair game.

This paper takes a "constitutional" or "contractarian" approach to taxes and transfers, and is based on a perspective first articulated by Frank Knight (1947), two applications first suggested by Richard Zeckhauser (1974), and a recent development of this perspective by James Buchanan (1985). As is so often the case, it is most appropriate to start with Knight. According to Knight (1947, p. 392):

Cato Journal, Vol. 6, No. 1 (Spring/Summer 1986). Copyright © Cato Institute. All rights reserved.

The author is Chairman of the Cato Institute and a former member of the President's Council of Economic Advisers. This paper summarizes one section of a longer paper, "A 'Constitutional' Perspective on Social Welfare Policy," prepared for a Ford Foundation conference on social welfare policy, November 3–5, 1985.

> All problems of social ethics are like those of play in that they have the two components of obeying the rules and improving the rules, in the interests of a better "game." . . . As a matter of course, every party in the game must 'play his own hand' to the best of his ability; otherwise there is no game. . . . Further, rigorous equality in the distribution of the results is self-contradictory. . . . The ethical ideal is a 'fair' and an interesting game.

A constitutional approach to taxes and transfers, thus, addresses the rules of the game, rather than the results of a specific play of the game. The distinctive assumption of this approach is that each person selects the rules affecting later taxes and transfers without knowledge of his specific position in the post-constitutional distribution of natural endowments. Given a consensus on these rules, unanimous post-constitutional agreement is neither a necessary nor sufficient basis for judging the fairness of the outcomes. In this sense, this approach is strictly individualistic but not strictly libertarian. The promise of this approach is based on the prospect of a much broader consensus on these rules than on any post-constitutional decisions on policies affecting the distribution of income.

For each application of this approach, each person is assumed to have a general understanding of human behavior, know his own preferences, know the post-constitutional distribution of natural endowments, but not know his specific position in that distribution. In this sense, these examples are better characterized by uncertainty rather than ignorance. Two specific assumptions are common to both examples: For each individual, the utility of the outcomes is proportional to the square root of disposable income and leisure, but the general results are common to any utility function with a declining marginal utility of each condition.[1] The distribution of natural endowments is symmetric, with a mean of $30,000, about equal to the current U.S. net national product per worker, in the first example, and a mean of $15 per hour, equal to $30,000 for a 2,000 hour work year, in the second example.

Redistribution of Unearned Income

The first example demonstrates the effects of different distributions of future income, given that all income is "manna," that is, independent of human effort.[2] Consider the following choice: An individual faces a lottery with a probability of .5 that he will receive an income of $12,000 or $48,000. A certain income of $30,000 would maximize utility. For the assumed utility function, however, he would prefer any certain income higher than $27,000 to this lottery and would be willing to pay the state up to $3,000 to provide the tax-transfer program. Table 1 summarizes the results of this type of choice for three distributions of natural income.

---

[1] Specifically, $U(y, z) = y^{.5} z^{.5}$, where y is the level of income after taxes and transfers, and z is the hours of leisure.

[2] This example was suggested but not developed by Zeckhauser (1974).

The first implication of this example is that the level of taxes and transfers increases with the variance of natural income. The first column, for example, could represent the choice of someone selecting social insurance for his own generation, and the third column the choice of the same person for the social insurance available to his distant grandchildren. This comparison illustrates that the difference between a person's decision on a law or on a constitutional rule is a matter of the degree of uncertainty, not a different type of analysis. A second implication is that the constitutional rule would limit the range of taxes and transfers but may not specify the amount. For the conditions of the second column, for example, taxes may range from $18,000 to $21,000, and transfers may range from $15,000 to $18,000, depending on the distribution of the social rent. This rent, which increases with the variance of natural income, could be used to administer the tax and transfer system, finance the protective and productive services of the state, increase transfers or reduce taxes, or could be wasted by the state or in various forms of rent-seeking activities—an allocation that cannot be fully determined at the constitutional stage. In this case, since all income is "manna," disposable incomes would be equal at some level between the equivalent income and the average natural income.

For some, this example may suggest a constitutional basis for a substantial tax on estates. Such an interpretation, however, would be strictly correct only if the level and distribution of the estate is

TABLE 1

REDISTRIBUTION OF UNEARNED INCOME

	Natural Income (Dollars per Year)		
Minimum	20,000	12,000	6,667
Maximum	40,000	48,000	53,333
Equivalent Income	29,142	27,000	24,428
Minimum Transfer	9,142	15,000	17,761
Maximum Tax	10,858	21,000	28,905
Maximum Rent	858	3,000	5,572

independent of the behavior of those who inherit the estate. In many cases, of course, people "earn" their inheritance by behavior that serves the interests of the person who leaves the estate. One should be cautious about weakening the ties that bind one generation to the next. Nevertheless, an inheritance is closer to "manna" than is most other forms of wealth, and there may be a constitutional consensus for a higher relative tax rate on income from this source.

Redistribution of Earned Income

A second example demonstrates the characteristics of the optimal tax and transfer system, given that taxes and transfers affect the hours worked, for a specific distribution of natural wage rates.[3] For this example, the observed wage rate is equal to the natural wage rate, that is, taxes and transfers are assumed to affect hours worked but not the choice of jobs or an individual's investment in his skills. An individual faces a lottery with a .25 probability of a natural wage rate of $6, $12, $18, or $24 per hour. The sum of taxes and transfers in this case is assumed to be equal. That is, no amount of taxes are necessary to administer the tax and transfer system or any other role of the state. The annual earnings are based on 50 weeks of work per year. Table 2 summarizes the characteristics of the tax and transfer system that maximizes expected utility for these conditions.

The most important implication of this example is that the marginal tax rates *decline* as a function of earnings. This induces those who are most skilled at generating earnings to work more than those who are less skilled and leads to a higher variance of earnings than of the

TABLE 2

REDISTRIBUTION OF EARNED INCOME

	Natural Wage Rate			
	$6	$12	$18	$24
Hours Worked per Week	27.8	41.5	46.7	49.7
Annual Earnings	8,347	24,900	42,016	59,584
Annual Transfers or Taxes (−)	6,095	1,222	−2,473	−4,844
Average Tax Rate (%)	−73.0	−4.9	5.9	8.1
Marginal Tax Rate (%)	33.3	25.6	17.6	9.4
Annual Disposable Income	14,442	26,122	39,543	54,740

---

[3] This example was fully developed by Zeckhauser (1974). The numbers presented in Table 2 are only a scalar change of the Zeckhauser calculations plus the correction of one error.

natural wage rate. Average tax rates, of course, increase with earnings, reflecting the redistribution of income from higher skilled workers. For this example, taxes and transfer payments are 5.4 percent of total earnings, and the variance of disposable income is only slightly less than the variance of natural wage rates. This example assumes that there is only one form of transfer payment, similar to a negative income tax. A superior solution may be to allow the poor to choose one of two forms of transfers, either a negative income tax or an earnings subsidy. Similar calculations for a tax and transfer system that includes an optional earnings subsidy, unfortunately, have not been developed.

Our current tax and transfer system differs from this example in two important ways. One, marginal tax rates are now much higher than the optimal rates for both the lowest and highest skilled workers. This reduces the hours worked and earnings of both of these groups. Second, government transfer payments are now about 13.5 percent of net national product, an amount that would be appropriate only if the variance of natural wage rates is much higher than in this example.

Effects of Other Conditions

For the same distribution of natural wage rates and the same utility function, any change in other conditions would *reduce* the total amount of transfers relative to this example.[4] Any marginal tax rate on earnings leads people to choose more pleasurable jobs and to invest less in human skills. Any tax on the income from new investment would reduce the size of the complementary stock of physical capital. Any expenditure for the protective and productive services of the state would reduce transfers unless it leads to an offsetting increase in total income. Any waste of resources by the state or in private rent-seeking activities would have a similar effect. Each of these probable conditions affecting the post-constitutional behavior of people and governments is realistic to expect at the constitutional stage and would lead to a lower preferred amount of transfers. And finally, the potential to emigrate or, with others, to secede from a state would limit the total amount of coercive transfers from any one individual to the difference between the value of residence in one state and that in the next best alternative, minus the personal costs of moving or of participating in an effective secession. Such rights of emigration and secession, moreover, are likely to be secured by a constitutional consensus, because they are consistent with the principle of maximum compatible liberty.

---

[4] The qualitative effects of changing these other conditions on the level of transfers is developed in a recent paper by Buchanan (1985).

Conclusion

Although some amount of social insurance may be preferred at the constitutional stage, a realistic consideration of these other conditions may lead to a set of constitutional rules that provides no authority for the redistribution of income. The U.S. Constitution, for example, provides no explicit authority for federal welfare programs. Article 1, Section 8, describes 18 specific powers of the federal government, without a hint that these powers authorize the redistribution of income or the provision of federal welfare services. The only constitutional authority for the modern welfare state rests on an obscure ruling by the Supreme Court in 1936, in *United States* v. *Butler,* that "the power of Congress to authorize appropriations of public money for public purposes is not limited by direct grants of legislative power found in the Constitution." Our contemporary national community may share a constitutional consensus for some amount of some types of federal transfers. Our contemporary problem, however, is that there are no effective constitutional limits on the amount or nature of these transfers.

References

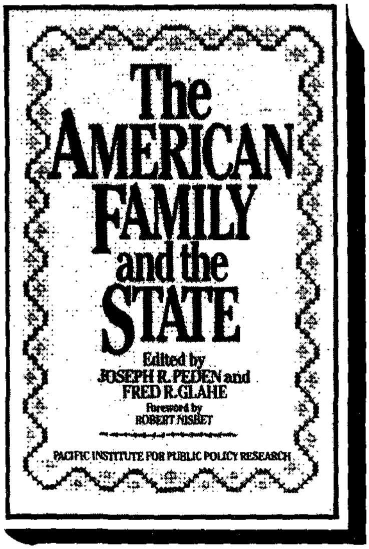
Buchanan, James. "Coercive Taxation in Constitutional Contract." Working Paper, Center for Study of Public Choice, George Mason University, 1985.

Hochman, Harold M., and Rogers, James D. "Pareto Optimal Redistribution." *American Economic Review* 59 (September 1969): 542–57.

Knight, Frank H. "The Sickness of Liberal Society." In *Freedom and Reform: Essays in Economics and Social Philosophy,* pp. 370–402. New York: Harper and Bros., 1947.

Zeckhauser, Richard. "Risk Spreading and Distribution." In *Redistribution through Public Choice,* pp. 206–28. Edited by Harold Hochman and George Peterson. New York: Columbia University Press, 1974.

FAMILY, SCHOOLS, AND THE STATE

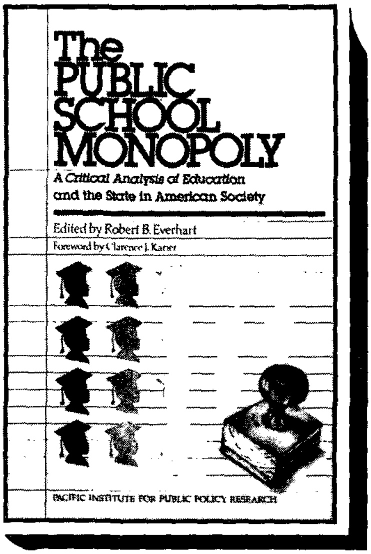

The
AMERICAN
FAMILY
and the
STATE
Edited by
JOSEPH R. PEDEN and
FRED R. GLAHE
Foreword by
ROBERT NISBET
PACIFIC INSTITUTE FOR PUBLIC POLICY RESEARCH

THE AMERICAN FAMILY AND THE STATE
Edited by JOSEPH R. PEDEN and
FRED R. GLAHE
Foreword by ROBERT NISBET

This unique volume assembles a comprehensive look at the modern family and how its increasingly serious problems relate to the intrusions of government. The authors analyze major family issues including the viability and role of mediating structures, the consequences of social welfare programs, and such problems as domestic violence, children's rights and parental authority, and teenage pregnancy. Those who have advanced orthodox conservative or liberal views of the family will be both challenged and fascinated.

"I am confident that the attentive reading of this fine and salutary study of state and family will carry us, administrators, politicians, and ordinary citizens alike, a long step forward in understanding the indispensability of the family to democracy and also the complexities which attend the family's relationship to democracy."
–ROBERT NISBET
Columbia University

482 pages, Cloth, 0-936488-12-3, $34.95
Paper, 0-936488-05-0, $14.95


The
PUBLIC
SCHOOL
MONOPOLY
A Critical Analysis of Education
and the State in American Society
Edited by Robert B. Everhart
Foreword by Clarence J. Karier
PACIFIC INSTITUTE FOR PUBLIC POLICY RESEARCH

THE PUBLIC SCHOOL MONOPOLY
A Critical Analysis of Education and the State in American Society
Edited by ROBERT B. EVERHART
Foreword by CLARENCE J. KARIER

The escalating problems of modern education have created the widely recognized need to critically reassess the public school system. This comprehensive book examines the relationship between schooling, education, and the state and how the state, through the regulation of primary and secondary schooling in the United States, restricts educational practice to an extent that is detrimental to the general public and especially to the disadvantaged. The contributions to this volume are diverse in content and approach, and range from left to right politically in their points of view. Together they provide a unified understanding of the many problems in education, and offer new directions for constructive policy reform, including alternatives to the public school system (vouchers, tax credits, private schools, etc.).

"This book is an important contribution to the question of how schools are best organized for our children's benefit. It questions the dogma that attends most discussions of education: that publicly supported education must also be provided by a state bureaucracy."
–JAMES S. COLEMAN
University of Chicago

600 Pages, Cloth, 0-88410-383-8, $34.95
Paper, 0-88410-38-9, $14.95

Available at better bookstores, or from
PACIFIC INSTITUTE, 177 Post Street, Dept. C
San Francisco, CA 94108

PACIFIC
INSTITUTE
FOR PUBLIC POLICY RESEARCH

JOURNAL OF MONEY, CREDIT, AND BANKING

VOLUME XVIII NUMBER 4 NOVEMBER 1986

MONEY, CREDIT, AND BANKING LECTURE

On "Real" and "Sticky-Price" Theories of the Business Cycle
Bennett T. McCallum

ARTICLES

Money Demand and the Effects of Fiscal Policies
N. Gregory Mankiw and Lawrence H. Summers

Divisia Aggregation and Substitutability among Monetary Assets
Apostolos Serletis and A. Leslie Robb

Unanticipated Money and the Political Business Cycle *Daniel J. Richards*

Tests of the Money Neutrality and Rationality Hypotheses:
The Case of Japan 1973–1985 *Maria S. Gochoco*

The Balance of Payments Offset to Monetary Policy:
Monetarist, Portfolio Balance, and Keynesian
Estimates for Mexico and Venezuela *Linda Kamas*

The Relative Yields on Taxable and Tax-Exempt Debt *Hal Heaton*

Pricing Returned Check Charges under Asymmetric Information
Gregory F. Udell

NOTES, COMMENTS

BOOK REVIEWS

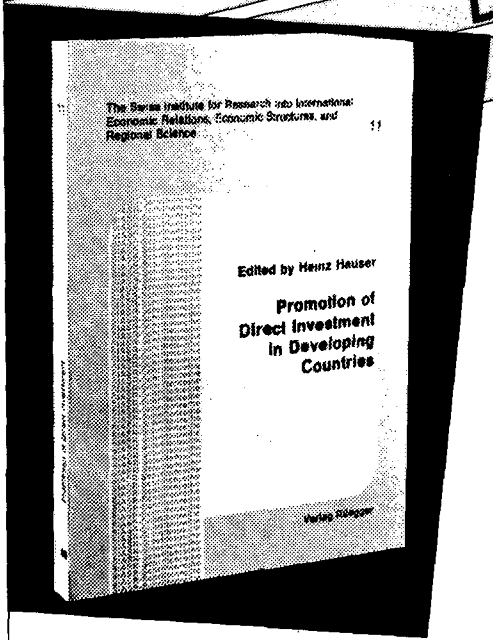
CUMULATIVE INDEX, VOLS. I-XVIII (1969-1986)

Published quarterly by **OHIO STATE UNIVERSITY PRESS**
1050 Carmack Road, Columbus, Ohio 43210-1002 (614) 422-6930

One-Year Subscriptions: $22 Individual $28 Library $17 Student

NEW

PROMOTION OF DIRECT INVESTMENT IN DEVELOPING COUNTRIES


The Swiss Institute for Research into International Economic Relations, Economic Structures, and Regional Science
11
Edited by Heinz Hauser
Promotion of Direct Investment in Developing Countries
Verlag Rüegger

- *The Debt Crisis and Foreign Private Investment*
- *Multinational Enterprise and Host Country Policy*
- *Promotion of Foreign Private Investment by the International Finance Corporation*
- *Investment Protection Treaties: Recent Trends and Prospects*
- *Multilateral Investment Guarantee Agency*
- *Coverage of Political Risk by State Insurance and by the Private Insurance Industry*

Leading representatives of the World Bank Group and host countries, members of multinational enterprises, and experts for investment guarantee schemes discuss reasons for decline and opportunities for improvement of foreign direct investment in developing countries.

Among the authors:			
	C. Fred Bergsten	*Helmut Maucher*	*Adolfo Hegewisch*
	Hans-Martin Burkhardt	*F. Javier Alejo*	*Max D. Amstutz*
	Ibrahim Shihata	*Julian Radcliffe*	*and others*

Please send ____ copy(ies) of
Promotion of Direct Investment in Developing Countries
1986, 150 pp, sFr. 28.— per copy

Name:
Address:
Country:
Signature:

Verlag Rüegger
Unterdorf 65
CH-7214 Grüsch
Switzerland

ELECTRONIC REPRODUCTION PROHIBITED

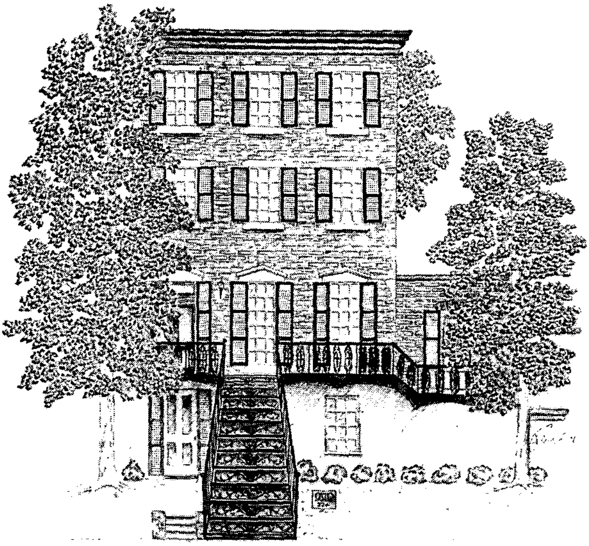
The Cato Institute

Founded in 1977, the Cato Institute is a nonpartisan public policy research foundation headquartered in Washington, D.C. The Institute is named for *Cato's Letters,* libertarian pamphlets that helped lay the philosophical foundation for the American Revolution.

The Cato Institute seeks to broaden the parameters of public policy debate to allow consideration of more options that are consistent with the traditional American principles of limited government, individual liberty, and peace. Toward that goal, the Institute strives to achieve a greater involvement of the intelligent, concerned lay public in questions of policy and the proper role of government.

The Cato Institute undertakes an extensive publications program dealing with the complete spectrum of policy issues. Books, monographs, and shorter studies are commissioned to examine the federal budget, Social Security, monetary policy, natural resource policy, military spending, regulation, NATO, international trade, and many other issues. Major policy conferences are held throughout the year, from which papers are published thrice yearly in the *Cato Journal.* The Institute maintains an informal joint publishing arrangement with the Johns Hopkins University Press.

In order to maintain an independent posture, the Cato Institute accepts no government funding. Contributions are received from foundations, corporations, and individuals, and from the sale of publications. The Institute is a nonprofit, tax-exempt educational foundation under Section 501(c)3 of the Internal Revenue Code.



The Watterston House headquarters of the Cato Institute

$6.00

THE REDISTRIBUTIVE STATE

In an open and free society, political action which deliberately aimed to minimize, or even remove, economic differences (i.e. differences in income and wealth) would entail such extensive coercion that the society would cease to be open and free. The successful pursuit of the unholy grail of economic equality would exchange the promised reduction or removal of differences in income and wealth for much greater actual inequality of power between rulers and subjects. . . .

The policy termed redistribution benefits some people by confiscating part of the incomes of others. The beneficiaries may be poor, but this is by no means always so. Major beneficiaries of redistribution include its advocates, organizers and administrators, notably politicians and civil servants, who are not among the poor. This outcome promotes the self-perpetuation of the process.

—P. T. Bauer

Equality, the Third World,
and Economic Delusion
(Cambridge: Harvard University
Press, 1981), pp. 8, 13.